HISTORY & PROBLEMS OF INDIAN CURRENCY

1835—1943

AN INTRODUCTORY STUDY

D K MALHOTRA

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PREFACE TO THE SECOND EDITION

This book was first written during 1938-39 with the limited objective of providing a clear and concise account of the main developments in our currency system during the last one hundred years and its first edition came out a few months after the outbreak of the war The war has given rise to some very important developments in the sphere of Indian currency and these have been covered in the present edition The shape of the material incorporated in the first edition has also been changed a little by addition, modification and amplification It is very difficult to write about any aspect of Indian war economy without quickly getting out of date For the scene changes even as one is looking at it and the latest information has to be pursued like will-o'-the wisp

The following words occurring in the last chapter of the previous edition embody the conclusion then reached about the future of Indian currency

> "It may take a long time yet for the international monetary position to become clear and stable With war in the offing it may get more confused and unstable An independent monetary policy alone can safeguard Indian interests in such an emergency. The past record of currency management in this country is not such as to inspire public confidence The excessive dependence of her monetary system on currency and credit changes in England has been a serious disadvantage for India This dependence must be ended and a monetary system suited to Indian needs and managed to promote Indian interests evolved "

The war has brought a wealth of experience and wisdom but has in no way necessitated the retraction or revision of that conclusion

This book is modest in its claims and invites no rigorous judgments But an attempt has been made to import into its pages something of a method of approach and spirit to which the author attaches great value. If ever there was a time when the Indian economist could live in his 'ivory tower' and put on the trappings of 'scientific purism', that time is now long past. Into the context of every economic problem of this our country, the mighty and yet unsolved political problem enters and over the whole of its economy it rolls out in its wide sweep like a sheet of lead. The Indian economist has to show a keener appreciation of this fact But at the same time, he cannot afford to let it grow into an obsession which would run away with his analysis and judgment Nothing will, of course, absolve him from the duty of being an unbiassed student of events but he will greatly fail if he does not endeavour, within the limits of his capacity and work, to function as the adviser and prompter of a long suppressed nation, heavy with the burden of many infructuous decades, but now gathering some quiet resolve to be on the move

Grateful acknowledgement must be made here of the kind help received from several friends and colleagues. Dr. L. C. Jain and Dr B. K Madan read large parts of the manuscript and offered helpful suggestions but they have, of course, nothing to do with the views or opinions expressed in the book. Prof C N. Vakil permitted access to the excellent library of the School of Economics at Bombay and Messrs. J K Mehta and P. M Shah allowed the use of the well-stocked library of the Indian Merchants' Chamber, Bombay

10th March, 1944 D. K MALHOTRA

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INTRODUCTION

A general acquaintance with the mechanism of foreign exchange is necessary to understand properly the history and problems of Indian currency The history of Indian currency is very largely a history of its fortunes vis-a-vis the British currency It may not, therefore, be out of place to give in the beginning of this tract a general idea of the causes underlying fluctuations of exchange between countries with different monetary systems

The need of exchanging one currency into another arises on account of differences in the currencies of a large number countries all over the world The currency of one country is useless *as currency* when taken out to another country England has its pound, United States of America its dollar, France its franc, Russia its rouble, Japan its yen, and India its rupee When payments have to be made by the government or people of one country to the government or people of another country, one currency must be exchanged into another This raises the important question how much of one currency will be given to get a certain quantity of the other In other words, how will the rate of exchange be determined ?

To answer this question in a way which will accord with the conditions of the actual world, it is necessary to consider two different sets of conditions, *viz* , conditions of free competition and conditions of control Rate of exchange is determined in a certain way and by certain forces in a free market for foreign exchange and in quite a different way and by different directives under conditions of control Conditions of free competition will have to be considered at some length and may be taken up first

Broadly, four cases may be considered to know how the rate of exchange is determined under conditions of free competition and how far its variations can go These four

cases are of .

(*i*) Two countries both on metallic standard—gold standard or silver standard.

(*ii*) Two countries, one on gold standard and the other on silver standard.

(*iii*) Two countries, one on metallic (gold or silver) standard and the other having paper currency not convertible into gold or silver.

(*iv*) Two countries, both having inconvertible paper currency.

I Case Two countries on metallic standard

A country is said to be on gold (or silver) standard when its unit of account is a gold (or silver) coin freely minted by the government, its paper currency is freely convertible into gold (or silver) coins and free export and import of gold (or silver) are allowed. The unit of account may also be a certain fixed quantity of gold (or silver) in uncoined form In that case, too, the country is said to be on gold (or silver) standard, though more strictly it should be said to be on gold (or silver) *bullion* standard.

Between two countries both having gold coins as units of account, the rate of exchange will *tend* to equal the ratio between the legally prescribed amounts of gold contained in the coins This ratio is described as the *mint par of exchange*. Before the last Great War, for instance, both England and France were on gold standard, the mint par of exchange being 25 francs to the pound. The rate of exchange that *actually comes to prevail* in the foreign exchange market is seldom equal to the mint par. It varies in response to changes in trade and a few other causes[1] but limits to its variations are set by the cost of transporting gold from one country to the other. This requires a little bit of explanation It is obvious that imports into a country from another country must *ultimately* be paid for in the currency of the exporting country. Imports from France

[1] Among these other causes are movements of capital, speculation, apprehension or actual occurrence of political disturbances and changes in the rate of interest

into England, for example, must be paid for by British importers in francs Similarly imports into France from England will have to be eventually paid for in British currency. Imports thus create a demand for the currency of the country from where they come and exports give a command over the supply of the currency of that country to which they are sent The price that people in a country will pay in terms of their own currency for the currency of another country will depend on the demand for and the supply of foreign currency In other words, the rate of exchange at any time will depend upon the relative amount of exports and imports If exports increase, the supply of foreign currency at the disposal of the country is extended and its price in terms of the currency of the exporting country will tend to fall, i e, a smaller amount of home currency will tend to purchase a given amount of it If, on the other hand, imports increase, the demand for foreign currency is extended and more in home currency will have to be given to purchase a given quantity of it or, in other words, the same amount of home currency will tend to purchase less of foreign currency.

The mint par, let it be assumed, is.

One £ 25 Francs

If now exports from England increase, one £ will *tend* to exchange for 26 francs

If imports into England increase, one £ will *tend* to exchange for 24 francs

These fluctuations in the rate of exchange due to changes in the balance of trade and other causes cannot, however, go beyond certain points under normal conditions Exchange of one gold coin into another gold coin will stop as soon as it becomes less profitable than a direct shipment of gold contained in the coin from or to the other country. If the cost of sending out gold contained in the coin is less than the cost of exchanging the coin for a foreign gold coin, export of gold will be preferred to exchange of currency in the foreign exchange market The rate of exchange cannot rise above or fall below certain points. As soon as these points are reached, people find export or import of gold cheaper than purchase or sale of foreign currency. These points are called *gold points* and are

found by adding to and deducting from the mint par the cost of transport of gold.

It only remains to add that foreign currency is bought and sold through banks (which collectively make up the foreign exchange market) and the media used for the purpose are bills of exchange which are simply orders to pay specified amounts of the currency of a country

An example to bring out the meaning of gold points.—

Upper gold point

Mint par. one £=25 francs

If exports from England increase, 1 £ will tend to exchange for more than 25 francs

Cost of transport of gold contained in a £ is, let us say, 1/4 franc

As soon as the rate of exchange in the market rises above 1£=25¼ francs, a British exporter will find it cheaper to get gold direct from France He will receive minus cost of transport more than 25 francs which are equivalent to more than a £ (mint par £=25 francs) No exporter will, therefore, receive less than one pound for every 25¼ francs from a bank This is the upper gold point. The rate of exchange cannot rise higher than this, for an import of gold into England will be induced

Lower gold point

Mint par one £=25 francs

If imports into England increase, 1 £ will tend to exchange for less than 25 francs.

Cost of transport of gold in a £=¼ franc

As soon as the rate of exchange in the market falls below 1 £=24¾ francs, a British importer will find it cheaper to export gold contained in a pound than to get francs through the bank By exporting gold directly he can remit, after paying cost of transport, 24¾ francs The rate of exchange cannot, therefore, fall below this point This is the lower gold point A fall below this point will lead to export of gold

The rate of exchange will therefore fluctuate between 24¾ and 25¼ francs to the £

Fluctuations of exchange and limits to them between two countries on silver standard are determined in the same way.

II Case Two countries—one on gold standard and the other on silver standard.

In this case there is no mint par as such The ratio between the metallic contents of the two currencies is variable, depending on the price of silver in terms of gold The rate of exchange, therefore depends upon three factors (*i*) the volume of exports and imports, (*ii*) gold price of silver and (*iii*) cost of transport of gold or silver from one country to the other The value ratio between silver and gold from the middle of the seventeenth century and throughout the eighteenth varied between 13⅝ . 1 and 15½ . 1 but after 1870 this ratio was disturbed[1]

A very good illustration of the determination of rate of exchange between a gold standard and a silver standard country can be obtained from the currency relationships of India and England during the nineteenth century From 1835 to 1893 India was on silver standard and England on gold standard. In 1871-72 when the price of silver was 60½*d* per ounce, the Indian rupee was equivalent to a little less than 2*s* After 1873, the price of silver in terms of gold fell. Naturally the price of silver in the rupee in terms of gold in the pound also fell. In 1893, when the gold price of silver was 39*d.* per ounce, the Indian rupee became equivalent to only 1*s* 3*d* During the same period fluctuations of exchange took place in response to changes in the balance of trade also—within the limits set by cost of transport of gold or silver from one country to the other

III Case and IV Case Two countries—one of which or both of which are on inconvertible paper standard.

These two cases may be considered together because they bear the same explanation In these cases, there is no mint par as such and the question of cost of transport of metal from one country to the other does not arise because in one or both of the countries the currency is not convertible into bullion or coin.

[1] Knut Wicksell *Lectures on Political Economy*, Vol II, p 36

Here the rate of exchange between the countries tends to equal the ratio between the purchasing power of the currencies of the two countries. If, for instance, one paper pound has the same purchasing power against commodities as five paper dollars, rate of exchange will oscillate about the parity . 1£ . $5 Exchange fluctuations will no doubt take place in response to changes in trade and other causes but will *centre round this purchasing power parity*

During the last Great War many countries went off metallic standards and inflated their paper currencies. The old way of explaining fluctuations in the rate of exchange became utterly inadequate A new explanation was necessary and this was provided by Prof. Gustav Cassel, the Swedish economist. He propounded the now famous theory of Purchasing Power Parity. The essence of the theory is that exchange rates reflect the relation between the internal purchasing powers of the currency units of different countries But as confusion and misunderstanding have been caused by this very simple statement of the theory, it has become necessary to distinguish between, what are described as, its positive and comparative forms In its positive form, the theory states that the ratio of purchasing powers of two currencies furnishes the equilibrium or normal rate of exchange round which the actual market rate fluctuates It was in this form that the theory was first expounded by Cassel but as it was found open to a number of objections by the critics, a different mode of its exposition was emphasized by the author. In its comparative form, the theory asserts that if an equilibrium rate of exchange has already been established between two countries and a change occurs in the purchasing powers of their currencies, then the new equilibrium or normal rate of exchange can be found by multiplying the old by the ratio of the change in the purchasing powers of the two currencies In Cassel's own words .—

" Our willingness to pay a certain price for foreign money must ultimately and essentially be due to the fact that this money possesses a purchasing power against commodities and services in that foreign country On the other hand, when we offer so and so much of our money, we are actually offering a purchasing power as against commodities and services in our

own country Our valuation of a foreign currency in terms of our own, therefore, mainly depends on the relative purchasing power of the two currencies in their respective countries When two currencies have undergone inflation, the normal rate of exchange will be equal to the old rate multiplied by the quotient of the degree of inflation in the one country and in the other There will naturally always be found deviations from this new normal rate and during the transition period these deviations may be expected to be fairly wide But the rate that has been calculated by the above method must be regarded as the new parity between the currencies, the point of balance towards which, in spite of all temporary fluctuations, the exchange will always tend This parity I call *purchasing power parity* ".[1]

The usual, though not always a satisfactory, method of measuring the purchasing powers of currencies is the use of index numbers of prices Changes in the general level of prices furnish the changes in the purchasing power of currency The example given below will give an idea of the purport of the purchasing power parity theory as also a rough method of calculating the parity

Mint par or the old equilibrium rate

	England		France
1913	£	=	25 Francs

Index Nos of prices

	England	France
1913	100	100
1920	300	500

Purchasing power parity or the new equilibrium rate ·

$$£ = 25 \times \tfrac{500}{300} \text{ francs}$$

$$\text{or } £ = 41\ 7 \text{ francs}$$

The figures taken here are true to facts to a small extent and the parity thus worked out also accords to some extent with the actual rate in January 1920

Into the refinements and criticisms of the theory it is needless to enter here. The theory has been accepted in

[1] Cassel *Money and Foreign Exchange after 1914*, pp 138-40

essentials and used to explain the normal rates of exchange and exchange fluctuations not only of inconvertible paper currencies but of currencies based on metallic standards as well. The mint par of exchange may in fact be considered just as much a ratio of the purchasing powers of the metallic contents of the currency units as a ratio of the metallic contents themselves. The parity of purchasing power is thus a wide parity and includes mint par of exchange

Normal rate, Overvaluation, Undervaluation, Devaluation, Depreciation

Terms like overvaluation and undervaluation are so much a part of the jargon of the currency expert that it is impossible to follow any serious discussion on currency matters without knowing their meaning They describe—as indeed the prefixes de- and under- indicate—an *abnormal* valuation of currency. To know their meaning, therefore, one must ascertain what constitutes the *normal* valuation of the currency unit of a country It is not easy to give a short and precise definition of the normal exchange value of currency or the normal rate of exchange. Far less easy is it to state exactly what the normal rate of exchange is under given conditions In a general way, the normal rate of exchange may be defined as one which prevails in, and brings about, conditions of equilibrium in the balance of payments and of general economic stability. This rate imposes no strain either on the balance of payments or on export industries , causes, consequently, no continuous outflow or inflow of gold , subjects the internal economy of a country to no undue stress and reflects the basic economic relations, including the relations of price levels, of one country and another. It follows that any other rate will give rise to a series of disturbances, maladjustments and disharmonies As a matter of fact, the normal rate can be picked out more by the absence of such unfavourable reactions than by any formal definition of its own

But the more important, because more practical, question is one of finding out the normal rate at a given point of time. As a good approximation it may be said that the purchasing

power parity constitutes the normal or equilibrium rate, that is to say, a rate at which the purchasing power of currency unit at home is equal to its purchasing power abroad (on its conversion into foreign currency) is the normal rate At this rate, the currency is neither overvalued nor undervalued If the rate of exchange be higher than the normal rate so that the currency unit purchases more abroad than at home, currency is said to be overvalued An overvalued currency depresses exports and export industries, stimulates imports and upsets the balance of payments, causes export of capital and gives rise to drain of gold The British pound between 1925 and 1931 provides a good example of an overvalued currency. A currency is said to be in a state of undervaluation if it purchases less abroad (on conversion into foreign currency) than it does at home An undervalued currency handicaps imports and encourages exports and stimulates an inflow of gold. The French franc was, at the parity chosen for it in 1928, considerably undervalued

When a currency is overvalued *i e*, when its external purchasing power is higher than its internal purchasing power, it can be brought back to its normal valuation in either of two ways - either its external purchasing power can be lowered or its internal purchasing power raised. Devaluation is the term used for the first alternative and may be defined as a reduction in the quantum of gold or foreign currency into which the currency unit is exchanged in the foreign exchange market The second alternative is deflation which may be defined, in this context, as a contraction of the quantity of currency in circulation with a view to raising the purchasing power of the currency unit Such contraction leads to a fall in prices and as certain items in cost of production, such as wages, may not fall to the same extent as prices, it may pare off profits and considerably discourage trade and enterprise From the standpoint of the requirements of internal economy, therefore, a country will usually prefer devaluation to deflation Considerations of international prestige and international economic relations may, however, dictate the other but less attractive course of deflation It is necessary to mention here that devaluation may be resorted to not only to cure the

disavantageous state of overvaluation but also to bring about the advantageous state of undervaluation.

The term ' devaluation ' is often used interchangeably for 'depreciation' but devaluation implies a deliberate and definite reduction in value while depreciation means simply a fall in value which may not necessarily be deliberate and is generally not definite and pre-determined.

Exchange Control

The foreign exchange market in which currencies acquire their value from the interplay of the forces of demand and supply functions more or less freely in normal times In times of disturbance or crisis, however, it is controlled or superseded by the monetary authority of the country (government, central bank or special organisation created for the purpose). Exchange control is the compedious term covering all those measures of control which involve abnormal intervention by the monetary authority in the foreign exchange market It aims at changing *directly* demand or supply on the foreign exchange market and thus marks a departure from the conditions of free competition.

The chief aim of exchange control is, of course, to make the rate of exchange different from what it would be in a free exchange market. This aim obviously implies that the monetary authority is not satisfied with the rate determined by forces of demand and supply and wants a different rate to prevail. This control rate may be higher or lower than the rate of the uncontrolled market or it may be just a very much stabilised rate free from the fluctuations of a free market

Exchange control is a product of unsettled times such as war, political upheaval or currency disturbance and is relaxed or removed with the return of normal conditions. It was adopted in most countries during the last war, was gradually relaxed and removed between 1926 and 1931 but was readopted in many countries after the currency crisis of 1931 With the outbreak of the present war it was introduced in countries where it did not already exist and was intensified in others. It would be wholly unrealistic now to speak of a free market in foreign exchange.

Inflation, Deflation, Reflation

These three terms do not refer to the state of foreign exchange market but to the condition of currency within a country. A brief explanation of them is being given here for two reasons firstly, the state of home currency has a direct bearing on its valuation in terms of foreign currencies and secondly, the present war has impinged on, and altered the state of, almost all the currencies of the world From the standpoint of present war economy and also of post-war monetary reconstruction a clear understanding of the significance of these terms is advisable.

Inflation is one of those economic terms which cannot be precisely defined and some well-known writers on money have either confessedly left some 'mistiness' about it or not attempted to define it with scientific precision[1] The general idea conveyed by the term is, however, happily not very much at variance with its most common definitions, it signifies an excess or superfluity of media of exchange, including notes and bank credit And when this much has been agreed upon, further discussion can only turn on what constitutes 'excess' or 'superfluity' and how and when such excess may manifest itself. It is here necessary not to forget that the total effective supply of money or currency in any country is the combined result of its quantity and its velocity of circulation This effective total supply is used for meeting the requirements of economic activity and from this interaction of money-supply and money-work, there results a certain general level of prices It is difficult to say what relationship between money-supply and economic activity[2] is the optimum or the best and how it can be identified (if it ever exists) but some such optimum relationship will have to be visualised in order to hit upon even a tolerably good definition of inflation

[1] Pigou in *Economics in Practice*, p 85 and L Von Mises in *Theory of Money and Credit*, p 240

[2] The term economic activity', used here in a comprehensive to cover production, trade, employment etc, appears to be more suitable than alternative terms sometimes employed, such as production, real income, real values, etc

Assuming, therefore, that an equilibrium between money-supply and economic activity has been established and a desirable level of prices prevails, if now this equilibrium is disturbed by an expansion of the total effective supply of money, inflation will be said to have taken place. An inevitable outcome of a larger supply of money acting upon an unchanged quantum of economic activity will be a rise in prices which is the most important manifestation of inflation. It is, however, possible that the equilibrium relationship between money-supply and economic activity may be disturbed not from the money side but from the commodity-side, that is to say, the requirements of the economic system for money may shrink but the supply of money may remain the same In this case also, inflation will occur and prices rise, not by the active act of increasing money-supply but through the passive act of letting it remain as it was.

It is further necessary to note that though a large and continuous *general* rise in prices is an important symptom of inflation, a rise in prices need not always indicate presence of inflation just as a stable level of prices need not necessarily indicate absence of it Prices in a country may rise because of the scarcity of many important commodities (caused, for instance, by failure of harvests) or because of the rise in world price level. Again, prices may be heading downward because of rapidly increasing productivity but the monetary authority of a country may, by putting increasing quantities of money in circulation, endeavour to maintain them at their old level There would be no inflation in the former case but there would be one in the latter. The state of price level does not, in other words, furnish an unfailing clue to the presence of inflation; it is necessary to go further and enquire why the price level is changing as it does A large and continuous rise in prices is, however, such an uncommon phenomenon that it may safely be taken to furnish a fairly strong evidence of inflation

It is necessary now to know why the equilibrium relationship of money-supply and economic activity should be disturbed at all, Normally, it may be said, there will be a tendency for such relationship to be established by the constant endeavour of the monetary authority of a country to adjust

the money-supply to the need for it It must, therefore, be an exceptional circumstance or emergency which hampers this process of adjustment and creates a maladjustment Inflation, as a rule, occurs when government, unable to meet its expenditure by the usual methods of levying taxes and raising loans, resorts to means which involve substantial additions to the total money-supply not offset by any corresponding need for them These means may be either the direct one of printing currency notes and using them for making the requisite purchases or the indirect one of borrowing from the central bank against securities and thus bringing about an expansion of the more widely used medium of exchange, *viz*, bank credit Inflation brought about by means of the former kind is often called currency or fiat money or paper-money inflation and that resulting from means of the latter type is generally described as banking or credit inflation [1]

Inflation is thus, to begin with, an easy and more or less inexpensive device for meeting an emergency which imposes a heavy strain on government finance But if the emergency lasts, it gradually gathers momentum For as prices rise, the government has to bring forth a rapidly swelling volume of fresh purchasing power to obtain a steady command over goods and services. This accentuates the rise in prices further. Goods and services thus become progressively dearer in terms of money or, what is the same thing, money becomes progressively cheaper in terms of goods and services In the later stages of this vicious process, prices begin to rise more than in proportion to the increase in the quantity of money in circulation because of the increased velocity of turnover of means of payment The process cannot continue *ad libitum*, for no one would wish to keep his assets in a currency that is fast losing in value and a time may come when no one would

[1] See for an elaboration of this definition of inflation *Public Finance* by A de Viti de Marco p 403n, also articles by Pigou in *Economic Journal* for the years 1918 and 1940 Anatol Murad's essay on 'Inflation in Current Economic Literature' included in Parker and Willis' *Economics of Inflation* is helpful so is American Research Institute s *What will inflation and devaluation mean to you*, 1941

care to accept it at all[1] This 'flight from currency' has its counterpart in the hoarding of commodities, particularly precious metals, jewellery, works of art and investment in dependable foreign currencies The flight is complete when the currency is no longer acceptable and a substitute is found for it This culmination marks the crash of the currency system—and the finale of inflation. An odious feature of inflation is the uneven rise in the money incomes of the different sections of the community; the fresh supplies of means of payment injected into the economic system find their way into some corners and crevices in greater profusion more than in others. The resultant rise in prices affects most adversely the persons with small or fixed incomes while for the traders, manufacturers and speculators, it creates a spell of illusory prosperity Inflation is, in effect, a measure of taxation, transferring to the government command over real resources but it is extremely indiscriminate, haphazard and inequitable in effects, inasmuch as it places the heaviest burden on the weakest shoulders and effects arbitrary redistribution of wealth

Deflation is, broadly speaking, the opposite of inflation and may be defined as a contraction in the total effective supply of money which is not offset by a corresponding diminution in the demand for money. Such contraction leads to a fall in the general level of prices, that is, to a rise in the value of money. Usually deflation is practised with the object of dealing with the excesses or aftermath of an inflation. The motive behind it is the raising of the value of currency to its previous level, in terms of gold or in terms of other currencies.

[1] During the German inflation of 1920-23—the classical example—prices and bank note circulation touched staggering figures The increase in note circulation proceeded at such a rate that 'in the last months before the collapse, more than 300 paper mills worked at top speed to deliver note paper to the Reichsbank and 150 printing companies had 2,000 note-presses running day and night to print the Reichsbank notes . Prices rose daily, almost hourly Money in the purse burned like fire, and everyone thought only how to get rid of it at the earliest opportunity" See Stolper *German Economy, 1870-1940*, pp 152-55

Reflation is the term used for that specific and limited kind f expansion of currency which aims at raising prices from a ower level which is considered unsatisfactory to a higher evel Such an expansion is advocated in times of depression vhen a large fall in prices has wiped out the margin of profit nd reduced business and enterprise to a stagnant state 'umping money into circulation—'priming the pump', as t is called—by judicious means is considered, under such onditions, a wholesome stimulant for industry and enterprise. 3ut a policy of reflation is beset with the risk of gradually engthening out into one of inflation.

CHAPTER I

A BRIEF OUTLINE

The history of Indian currency can be divided into more or less defined periods It may be taken to date from 1835—the year in which the rupee was established as the standard coin throughout the territories of the East India Company The following periods may be marked .—

I Period · 1835—1893, during which India was on silver standard. This period may further be split up into two periods (*a*) 1835—1874, during which efforts made to secure gold currency for the country proved abortive and (*b*) 1874-1893, during which the gold price of silver fell and led eventually to the suspension of silver standard.

II Period . 1893—1898 . A period of transition which was to precede introduction of gold standard with gold currency

III Period . 1899—August, 1917 . A period during which the Government set out to establish gold standard but drifted on to gold exchange standard

IV Period : August, 1917—1920 A period of unstable exchange during which the Government took measures to regulate currency.

V Period February 1920—September 1920 : A short period during which the Government tried unsuccessfully to restore stable gold exchange standard by holding the exchange at 2*s* (gold) and involved Indian exchequer in a huge loss.

VI Period 1920—27 A period during which the Government gave up attempts to *maintain* a particular exchange rate, but not those to *secure* a particular exchange rate.

VII Period . 1927—September, 1931 . A period during which gold exchange standard (actually sterling exchange

standard) was restored and efforts continuously made to maintain the rate at 1*s*. 6*d*.

VIII Period September 1931—August 1939: A period of crisis and uncertainty which began with rupee being linked to sterling and during which the Indian currency system weathered the economic storm.

IX Period September 1939—August 1943 Four years of the war during which the Indian currency system has undergone some unprecedented and startling changes and during which the monetary authorities, led by the necessities of war, have imposed various controls over currency and exchange

It would be helpful to know that running like two threads through the history of Indian currency are the desire of Indian people to have a gold standard and the anxiety of the Government to maintain a stable exchange rate at all costs. The present war has thrown the monetary systems of the world into the melting pot Old notions and predispositions may well be out of date at the end of war and if the currency plans now being drawn up and discussed are any clue to the future, the currency system of India, like the currency systems of other countries, will emerge from the present ordeal considerably modified and, one may hope, reformed and strengthened.

CHAPTER II

I Period 1835—1893

FROM ADOPTION TO ABANDONMENT OF SILVER STANDARD

Attempts by the East India Company to reform Indian currency had begun much before 1835 and the silver rupee weighing 180 grains (11/12th fine) was made the standard coin in Madras in 1818 and in Bombay in 1823.[1] In 1835 (by the Act No XVII) the silver rupee of 180 grains (11/12th fine) was made the standard coin throughout British India.[2] Mints were opened to the free coinage of silver. The face value of the rupee was equal to its intrinsic value, *i e.*, the value of the rupee against gold or commodities was equal to the value of silver contained in the rupee. It must be obvious that coinage being free to public it was not possible for the Government to make the rupee circulate at a value higher than that of silver put in the rupee.

§ 1. ATTEMPTS TO INTRODUCE GOLD IN CIRCULATION (1835—1874)

By the Act of 1835, which made the silver rupee standard coin, gold coins were deprived of their legal tender quality, *i e.*, legally they could not be paid and accepted The Act permitted, however, the coinage of gold mohars if required by the public. These mohars were to be equal in value to 5, 10, 15, or 30 rupees It is difficult to understand why the gold coins struck under the Act were not to be legal tender

[1] Reform was needed because of the large variety of coins of gold and silver circulating in different parts of the country 994 coins of varying weight and fineness are said to have been circulating about this time

[2] The weightand fineness of the rupee remained unaltered upto 1940

A proclamation issued in 1841 authorised receipt of gold coins at public treasuries in payment of public dues at their face value unless they had passed a certain limit of lightness when they were to be taken as bullion only, by weight. The rate at which gold coins were to be received was 15 1. Some encouragement was thus given to gold currency but it was to be very brief. Gold discoveries in California and Australia from 1848 to 1851 made it cheaper for the people to pay in gold rather than silver at the rate of 15 1 Gold began to flow to the treasuries in large quantities and the Government lost by accepting it at a rate higher than the market rate. From 1st January, 1853, therefore, receiving of gold coins in payments of public dues was stopped. Gold, however, continued to be received into the mint for coinage under the Act of 1835

Mansfield Commission, 1866

Proposals were made after 1853 to introduce gold currency in India Several Chambers of Commerce and Sir Charles Trevelyan (in his Minute of 20th June, 1864) pressed for the introduction of gold coins in India and the Government of India agreed to receive and pay, when convenient, sovereigns and half-sovereigns minted at any authorised mint in England or Australia at the rate of Rs 10 and Rs 5 respectively. The gold coins were not to be legal tender, however. At these rates gold coins were not tendered at the treasuries. A commission was appointed in 1866 under the chairmanship of Sir William Mansfield to report on the best way of meeting the currency demands of the country. The Commission made the following recommendations —

(i) gold coins of 15, 10 and 5 rupees should be issued

(ii) currency should consist of gold, silver and paper.[1]

(iii) the possibility of issuing a universal note should be

[1] Currency notes had been issued and made full legal tender within their respective circle of issue by the Paper Currency Act of 1861 The Commission were to report on the working of this Act also

considered[1]

Nothing resulted from these recommendations. In 1868, the rate for sovereigns and half-sovereigns was raised to Rs 10-4 and Rs 5-2 respectively to attract gold to the treasuries Shortly after this the gold price of silver began to fall and in May 1875, the Governor General-in-Council expressed his unwillingness to take any step to recognize gold as the standard of value in India

§ 2. FALL IN THE GOLD PRICE OF SILVER (1874—1893)

From 1874 onwards the gold price of silver began to fall From $60\frac{3}{4}d.$ per ounce in 1871-72 it fell to $39d.$ in 1892-93. From 1873 to 1893, the fall amounted to 40%. As the silver rupee was a freely minted coin, the value of silver in the rupee in terms of gold also began to fall and the rate of exchange fell from $1s.$ $11\frac{1}{8}d.$ to $1s.$ $3d.$ in 1892-93. There were two kinds of causes accounting for the fall in the gold price of silver :—

(*a*) Depreciation (fall in value) of silver due to increased production of silver and demonetization of silver by several countries such as Germany, Sweden, Denmark, Norway, etc.

(*b*) Appreciation (rise in value) of gold owing to its decreased production and increased demand from countries adopting gold standard such as Germany and Scandinavian countries.

For a long time the Government took no action and waited for the introduction of international bimetallism. The last of the International Monetary Conferences held at Brussels in 1892 adjourned without arriving at any agreement. The difficulties of the Government and people had in the meantime become acute owing to the following reasons :—

(*i*) To meet their Home Charges (*i e*, expenditure in England) they had to remit a larger number of rupees and

[1] To anticipate things a little, it may be mentioned here that five rupee note was made universal legal tender in 1909, ten and fifty rupee notes in 1910 and hundred rupee note in 1911 Five hundred and one thousand rupee notes were made universal legal tender in 1931

ıis necessitated increased taxation.

(ii) Fluctuations of exchange introduced uncertainty so armful to trade It is sometimes said that a falling exchange imulates exports but there was evidence to show that the rogress of export trade was less with a rapidly falling than ıith a steady exchange[1]

(iii) The European officials who made remittances abroad aimed compensation for the loss they suffered due to a ıll in exchange The prices in England had no doubt fallen : that time but even allowing for that the amount of erling which the same number of rupees procured had been rgely reduced.

(iv) A falling exchange greatly checked the investment of ritish capital in India because there was uncertainty as to ıe interest received from such investment and the reduction ıat the principal sum may suffer when it was transferred to ngland at a lower rate

(v) A falling exchange, involving as it did smaller remittnces for the same number of rupees, made it more difficult ı arrange for the services of European employees to carry on ıdustrial undertakings in India.

The Herschell Committee, 1892

In 1892, a committee was appointed under the chairmanıip of Lord Herschell to consider if it was expedient to close he mints to the free coinage of silver with a view to the ıtroduction of gold standard, as was suggested by the Governıent of India The object of closing the mints to the free oinage of silver was to secure control over the supply of ıpees and thus prevent a fall in the exchange value of the upee The Herschell Committee recommended that.—

(i) Mints should be closed to the free coinage of both lver and gold,[2] but the Government should retain the liberty ɔ coin rupees if required by the public in exchange for gold

[1] Report of Herschell Committee (1893), para 27

[2] This deserves notice because the Act of 1835 and later the Indian oinage Act of 1870 permitted coinage of gold for the public though gold as not legal tender The Act of 1893 stopped even coinage of gold

received in Government treasuries at the rate of 1s. 4d. : Re.

(ii) The rupee must remain full legal tender

Regarding the introduction of gold coins in India, the Committee did not attach any importance to the objection that Indian people were not used to them. "Gold", they said, "has never been entirely out of use in India" and, in any case, the ordinary currency in India would still be silver or paper though based on gold Moreover, if gold coinage were introduced on proper basis, much of the uncoined gold in India would be brought to the mints [1]

By Act No. VIII 1893, mints were closed to the free coinage of silver though the Government retained the power to coin rupees on their own account Three notifications (Nos 2662-64) were also issued making arrangements for (*a*) the receipt of gold at the mints at the rate of 7 53344 grains of fine gold per rupee or 16*d* Re.[2] (*b*) receipt of sovereigns and half-sovereigns in payment of public dues at 16*d* Re and (*c*) issue of currency notes to the Controller General in exchange for British gold or gold bullion [3] The aim of the Act and the notifications was to raise the gold value of the rupee to 1*s* 4*d.* by restricting its supply, make it effective at that rate and then to introduce gold standard [4]

It may be of some interest to note that the total coinage of rupees during the currency of silver standard in India from 1835 to 1893 amounted to 335⅓ crores of rupees [5]

[1] Report of the Herschell Committee, 1893, paras 99-103

[2] This notification was later on withdrawn in 1906

[3] This notification was supplemented by the Paper Currency Act of 1910 which provided for issue of notes against British gold coin

[4] Lords T H Farrer and R E Welby, two members of the Herschell Committee, had pointed out in a separate note that if gold does not flow into Government reserve against paper issue automatically, 'a reserve (of gold) should be provided before the Indian Government takes the final step of announcing gold as the standard, coupled with the correlative obligation to give gold for silver' *Report*, p 56

[5] Report of the Head Commissioner of Paper Currency Calcutta for the year 1896-97, p 19

CHAPTER III

II Period 1893-1898

A PERIOD OF TRANSITION

In a telegram of the 22nd January 1893, the Government India had said, " We think that an interval of time, the igth of which cannot be determined beforehand, should pse between closure of the mints and any attempt to coin .d here" During this interval which extended from 1893 to 98, the exchange value of the rupee fell in the beginning so v as 1*s*. 1*d* in 1894[1] but recovered later and was 15·9*d* in 98 The Government of India now made proposals to end : period of transition and to take " active steps to secure the ly establishment of a gold standard and a stable exchange " ese proposals were (*i*) to raise the rate to 16*d* (it was then a .le less) by withdrawing some rupees from circulation and lting them, (*ii*) to raise a loan in England and to remit part it to India in sovereigns to serve as gold reserve againt note- ue, (*iii*) to sell silver bullion obtained from melted rupees d add gold to the reserve and (*iv*) to part with gold only er the rate had been established at 16*d*

The Fowler Committee, 1898

In 1898, a committee was appointed presided over by Sir nry Fowler to consider these proposals for making effective e policy initiated in 1893 The committee had also to suggest iys of securing a satisfactory system of currency and stable change.

[1] This was due to suspension of silver purchases by America and an prehension about a fall in the value of silver rupees which were, there- e, brought out of hoards to be disposed of before further fall occurred

The Committee had before them three broad alternatives: (*i*) re-opening the mints to the free coinage of silver *i.e.*, reversion to silver standard (*ii*) continuance of the existing arrangements and (*iii*) the introduction of gold standard, with or without gold currency. The Committee was against reverting to silver standard because it would result in renewed instability of exchanges between India and gold standard countries, hamper international trade and revive the difficulties that the Government of India had to face in meeting their obligations in England They were also against allowing the *status quo* to continue because it would cause additional uncertainty and raise doubts as to the ultimate success of gold standard in India.

The Committee, therefore, came to the conclusion that the government should proceed with measures for the effective establishment of a gold standard Among the three different schemes of gold standard placed before the Committee, those of Mr Lesley Probyn and Mr. A. M. Lindsay provided for gold standard without gold currency while the Government of India's scheme favoured gold standard *with* gold currency The Committee rejected the first two schemes and made the following recommendations —

(*i*) The British sovereign should be made a legal tender and a current coin in India. Indian mints should be thrown open to the unrestricted coinage of gold on such terms and conditions as govern the three Australian branches of the Royal Mint

(*ii*) The rate of exchange should be made stable at 1*s* 4*d* . Re

(*iii*) Rupees should remain unlimited legal tender.

(*iv*) The Government should continue to give rupees for gold but fresh rupees should not be coined until the proportion of gold in the currency is found to exceed the requirements of the public

(*v*) Any profits on the coinage of rupees should be accumulated in a special reserve fund

(*vi*) No legal obligation should be imposed on the Government to give gold for rupees , for this would make the Govern-

ment liable to find gold at a moment's notice in undefined amounts

(*vii*) The Government should make gold available for export if exchange shows a tendency to fall below the specie point

In two respects the currency system recommended by the Committee differed from the ordinary gold standard In the first place, though gold coins were to be freely minted and were to be full legal tender, there was to be no *legal* obligation on the Government to convert rupees into gold Secondly, the rupees, quite unlike subsidiary coins under gold standard, were to remain full legal tender.[1] The Committee, it is clear, looked forward to the ultimate establishment of gold standard with gold currency and had meanwhile recommended for adoption a close approximation of it.

[1] Cf however, "It is sometimes erroneously believed that the proper position of a rupee under a gold standard is not to be unlimited legal tender" L C Jain, *Monetary Problems of India*, p 29 The question was discussed by the Fowler Committee, vide *Report*, paras 56-59

CHAPTER IV

III Period · 1899—*August* 1917

EVOLUTION, MECHANISM AND BREAKDOWN OF GOLD EXCHANGE STANDARD

§ 1. EVOLUTION OF GOLD EXCHANGE STANDARD

The effective establishment of gold standard was the paramount object which the Fowler Committee set before the Indian authorities The Government of India decided to take action on the recommendations of the Committee. The Indian Act No. XXII of 1899 made the sovereign and half-sovereign legal tender throughout India at Rs 15 : £ (*1s. 4d* : Re.). Active steps were taken to open a mint for the coinage of gold in India but the scheme was dropped after nearing completion in 1902. A reserve, called the Gold Reserve, was created to set apart the profits on the coinage of rupees. An active effort was made to induce the people to use sovereigns as a medium of exchange and Currency Offices, Post Offices and Government institutions were instructed to pay out sovereigns to the public. The results were unsatisfactory and a large number of gold coins were returned to the Government treasuries In many places sovereigns went to a discount of as much as 4 annas At the same time there was such a large demand for rupees that the Government were compelled to resume the coinage of rupees early in 1900 [1] The profits on the coinage were credited to the

[1] From 1894 to 1897 there had been no coinage of rupees, from 1897 to 1899 no new rupees were coined, coinage was on a small scale and was done mostly on account of some Indian states adopting British rupee in place of their own silver coin There was a phenomenal coinage in 1900-1901 of a little over Rs 17 crores and "the Currency Department was hardly able to comply with the demand" (vide *Reports of the Head Commissioner of Paper Currency*, 1896-97 to 1903-04)

Gold Reserve. After 1900 the experiment of putting gold coins into circulation was not repeated Apparently it was concluded by the Government that people did not want gold coins The conclusion was wrong because both the time and manner of putting gold coins into circulation were ill-chosen. Famine conditions prevailed about this time and rupees were needed for small payments The method of forcing sovereigns simultaneously from several sides on the people was hardly correct. With the odds heavily against them the Government tried to take the citadel by storm and when the first attack was repulsed threw up their hands in despair

After this, the currency system steadily deviated away from the aim of an effective gold standard In 1900 the experiment of making people use gold coins failed In 1902, the scheme of gold mint was dropped owing to the disapproval of British Treasury authorities [1] In the same year the arrangement initiated in 1898 of issuing currency notes against gold received by the Secretary of State in London was made permanent.[2] In 1904 the Secretary of State notified his willingness to give rupees for sterling without limit at a rate based on 1*s*. 4*d* . Re. The reserve constituted out of the profits on the coinage of rupees—the Gold Reserve—was remitted, according to the Secretary of State's decision, to London in gold and invested in sterling securities. The original object of this reserve was to ensure convertibility of Indian currency into gold at 1*s* 4*d* Re and thereby make gold standard effective The Secretary of State, however, held that as a large demand for conversion

[1] One of the reasons for disapproval was that sovereigns were being rapidly attracted to India whenever required and there was no reason for believing that the position of gold standard in India would be strengthened or public confidence in the intentions of the Government of India confirmed, by the mere provision of machinery for the manufacture of gold coins in the country "

(*Government of India Despatch quoted in the Minute of Dissent to the Hilton Young Commission s report*, p 105)

[2] The gold received by the Secretary of State was kept as a part of the reserve to back Indian Paper Currency This reserve—known as the Paper Currency Reserve—was meant to ensure convertibility of currency notes into rupees and gold coins and was held hitherto in securities silver and gold. Now a part of it came to be held in gold in London

of rupees into gold would arise only in an emergency when balance of trade turned against India and large payments had to be made in London, the Reserve should be kept in London. The Fowler Committee never intended that the reserve should be so kept nor could they ever dream that the Reserve would be drawn upon, as it was actually drawn upon in 1907 to the extent of £1,123,000, for expenditure on railway development. In 1907 a rupee branch of the Gold Reserve was created to ensure ready supply of rupees in exchange for gold tendered in India at 1*s* 4*d* : Re and to prevent thereby a rise in the exchange rate The name of the Reserve after the creation of this branch was changed into Gold Standard Reserve which now consisted of a rupee portion and sterling securities portion. In 1908 when the balance of trade turned against India, exchange tended to fall and there was a strong demand for gold for export, the Government after much hesitation made available gold out of the London branch of Gold Standard Reserve against rupees received by them in India [1] More than £8 millions were withdrawn out of the London branch of Gold Standard Reserve.

All these various steps taken by the Government of India were nowhere recommended by the Fowler Committee. It appears that after having got loose of the sheet anchor of gold standard, the Government policy steadily drifted quite unconscious of the destination to be reached. The various steps the Government took during this period were in the nature of

[1] The composition of the Gold Standard Reserve at the beginning of 1908-09 was as follows —

	£
Purchase value of sterling securities	13,186,521
Coined rupees held in India	4,000,000
Gold temporarily forming part of balances of Secretary of State	1,131,223
Outstanding debt from treasury balances	310
Total	18,318,054

By the end of the year, the value of coined rupees held in India increased to £10,586,734 and that of sterling securities declined to £7,414,510

(*Reports of the Head Commissioner of Paper Currency* for 1908-09 and 1909-10)

experiments to maintain the value of the rupee at 1*s* 4*d* These steps led, however, to the adoption by India of a new kind of currency system known as Gold Exchange Standard. This system had no basis in law, for it was the result of a series of administrative acts. It was not adopted as a consistent whole, for it was never consciously designed

As this system functioned upto 1917 in spite of the stress and strain of early war years, its mechanism may be clearly explained.

§ 2 MECHANISM OF GOLD EXCHANGE STANDARD

The germs of a system resembling Gold Exchange Standard are to be found in the writings of Ricardo, the famous British economist, who believed that a currency is in its most perfect state when it consists of a cheap material which has an equal value with the gold it represents The gold is available for purposes of export only and does not enter into the internal circulation of the country A system resembling the one advocated by Ricardo was introduced in several countries in an imperfect form but India was the first country to adopt it in a complete form [1]

The essentials of Gold Exchange Standard system are three —

(i) A cheap currency consisting of tokens In India it consisted of silver rupees, half-rupees and currency notes which were unlimited legal tender

(ii) The currency is not convertible into gold for internal use but the Government or the Central Bank of the country makes gold (or the currency of a country on gold standard) available to the people for purposes of foreign payments at a fixed rate in return for cheap internal currency. In India, the Government made arrangements for converting internal currency into British currency based on gold

(iii) Funds or reserves are kept in a foreign country to make gold (or currency of a gold standard country) availabe to the

[1] J M Keynes *Indian Currency and Finance*, p 33

people for foreign payments. In the case of India the Gold Standard Reserve was constituted.

One great merit of such a system is that the country avoids the use of a costly gold currency but has gold at its command to make foreign payments.

The Gold Exchange Standard in the form in which it was adopted in India is known as the Lindsay Scheme. Mr. A. M. Lindsay, the Deputy Secretary of the Bank of Bengal,[1] in his evidence before the Fowler Committee proposed a system only slightly differing from the one which was ultimately adopted. The Committee rejected the scheme on three grounds:

(*a*) any system without a visible gold currency would be looked upon with distrust.

(*b*) Flow of capital to India would be checked.[2]

(*c*) India's gold standard would come to be based on a few millions of gold (or rather command over gold) kept in London.

Mr. Lindsay had always maintained that " they *must* adopt my scheme despite themselves " and he was right.

The Gold Exchange Standard system was worked in India by the sale of Council Drafts and Reverse Council Drafts. Council Drafts or Rupee Drafts were orders by the Secretary of State to the Government of India to pay rupees. These orders might be sent by post when they were called Council Bills or in a telegraphic form when they were called Telegraphic Transfers. These " orders " were sold to British banks, firms and importers in exchange for sterling (*i e.*, British money) received from them. The net result of the sale of Council Drafts was that the Secretary of State received sterling and the Government of India released an equivalent amount of rupees. The rate at which Council Drafts were to

[1] Before the establishment of Imperial Bank in 1920 there were three Presidency Banks, in Bombay, Bengal and Madras

[2] Presumably due to the distrust and uncertainty of foreign investors about the return on their investments in the absence of an effective gold standard

e sold was announced by the Secretary of State Council Drafts had been sold even before 1893 but only to the extent to which funds were required by the Secretary of State to meet certain expenses (called Home Charges) on behalf of the Government of India Instead of British importers of Indian goods sending sovereigns to India, people tendering them to the Government in exchange for rupees and the Government of India sending them back to London to meet their Home Charges, sovereigns were received by this method by the Secretary of State directly from British importers, the Indian exporters being paid in rupees After 1893, however, the sale of Council Drafts was extended beyond the requirements of Secretary of State and in 1904 the Secretary of State announced his willingness to sell Council Bills on India *without limit* at 1*s* 4$\frac{1}{8}$*d*. . Re. By this means the balance of exports over imports could be paid for in London without the export to India on private account of more gold than was required by the people. By offering Council Bills in London the Secretary of State began to facilitate the course of Indian trade. He also got a lever by which he could prevent the rate of exchange from rising higher than 1*s* 4$\frac{1}{8}$*d* Re. It is obvious that so long as the Secretaty of State offered one rupee for every 1*s*. 4$\frac{1}{8}$*d*. received by him, no person wishing to remit money to India would have paid more than 1*s* 4$\frac{1}{8}$*d* for a rupee to any other person or bank nor would any one care to ship gold or sovereigns direct to India

The sale of Council Drafts was one facet of the Gold Exchange Standard system, the other being the sale of Reverse Council Drafts The Reverse Council Drafts or Sterling Drafts[1] were orders by the Government of India to the Secretary of State to pay sterling (*i e*, British currency) in return for rupees received by them The result of the sale of Reverse Council Drafts[2] was that the Government

[1] So called because they were sold in a reverse direction to Council Drafts

[2] Council Drafts and Reverse Council Drafts are often referred to shortly as 'Councils" and "Reverse Councils"

of India received rupees and the Secretary of State released from his funds sterling. The *demand* for Reverse Councils, unlike that for Councils, arose rarely, for Reverse Councils would be demanded only when the payments to be made abroad were larger than those made by foreigners to this country and this could happen only when imports were larger than exports. Reverse Councils were not sold below the rate of Re. : *1s* $3\frac{29}{32}$*d*

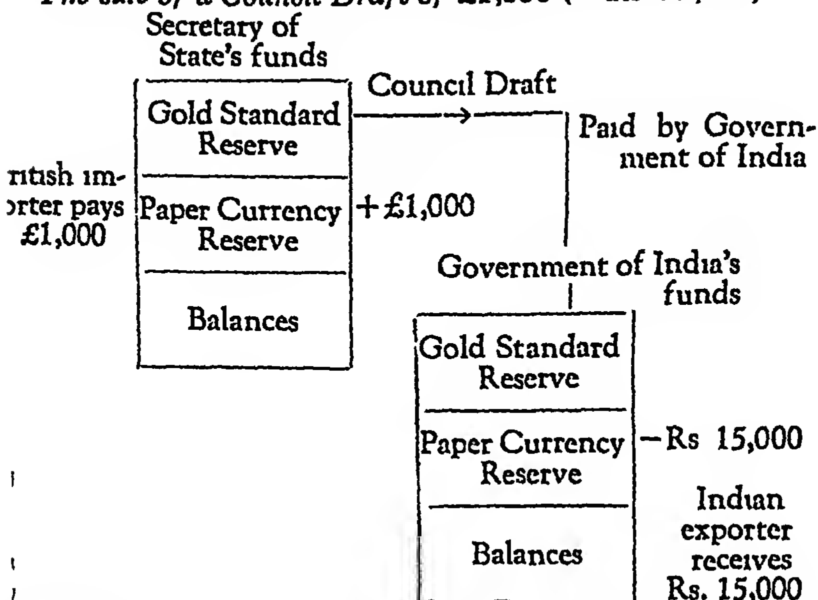
By the sale of Councils and Reverse Councils the exchange was prevented from deviating very much from a fixed rate—*1s. 4d* . Re. *It could fluctuate between 1s.* $3\frac{29}{32}$*d. and 1s.* $4\frac{1}{8}$*d* to the rupee.

To complete the explanation, a few words may be added about the funds out of which the Councils and Reverse Councils were paid out. The proceeds of the sale of Councils were credited partly to the Secretary of State's balances, partly to Paper Currency Reserve held in gold in London[1], and partly to Gold Standard Reserve. The Councils were paid out of the Government of India's balances, the Indian portion of Paper Currency Reserve or rupee branch of Gold Standard Reserve. The proceeds of the sale of Reverse Councils were credited to balances or Paper Currency Reserve by the Government of India and they were paid out of balances or Gold Standard Reserve by the Secretary of State. Thus the balances, Paper Currency and Gold Standard Reserves (with their respective functions of meeting current requirements, backing paper currency and meeting Reverse Councils) were in practice used indiscriminately to maintain

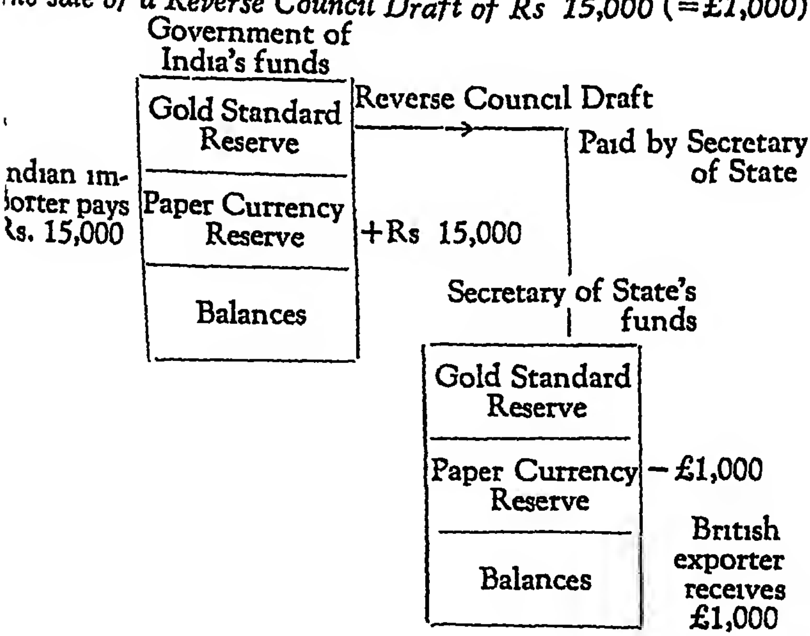
[1] The Paper Currency Reserve was the Reserve held against currency notes in circulation in India The Act of 1861 provided for the issue of a maximum of Rs 4 crores of currency notes against securities held as part of the Reserve, the rest of the Reserve being held in silver coin By 1911 many changes had taken place in the composition of the Reserve The amount of note-issue against securities had been raised to Rs 14 crores and the Reserve had come to consist of, besides securities (both rupee and sterling securities), gold coin and bullion and silver coin and bullion It was held partly in England and partly in India subject to the proviso that all coined rupees were to be kept in India

e exchange value of the rupee The diagram given below lustrates the mechanism of gold exchange standard.

The sale of a Council Draft of £1,000 (=Rs 15,000)



he sale of a Reverse Council Draft of Rs 15,000 (=£1,000)



The Chamberlain Commission, 1913

The views of the Chamberlain Commission about this system may be stated briefly. The Commission was appointed under the chairmanship of Mr. Joseph Austin Chamberlain in 1913 to enquire into the methods of maintaining exchange and the location and use of the reserves and balances and to report whether the existing practice was conducive to the interests of India [1] The Commission found the Gold Exchange Standard most suited to the conditions in India They were of opinion that to encourage an increased use of gold in internal circulation was not to India's advantage and that the people of India neither desired nor needed gold as currency There was no need of a mint for the coinage of gold but if Indian sentiment demanded it and the Government were prepared to incur the expense, one might be established for the coinage of sovereigns and half-sovereigns. If a mint could not be opened, the Government should renew the notification withdrawn in 1906[2] to receive gold at the Bombay mint in exchange for notes or rupees

About Gold Standard Reserve they held that no maximum limit to its amount could be laid down but a much larger portion of it should be held in gold. The proper place for the location of the Reserve, they said, was London The abolition of rupee (Indian) branch of the Reserve was recommended

The Paper Currency system, they recommended, should be made more elastic by issuing a larger amount of notes against securities [3] The use of notes as part of the currency should be encouraged and 500 rupee note universalised

The Commission also recommended that the Government should definitely undertake to sell bills in India on London at

[1] The Commission did not visit India and examined only a limited number of witnesses from India

[2] See page 22, footnote 2

[3] The amount of note-issue against securities (fiduciary issue) could be increased only by resort to legislation and so a large metallic reserve had to be kept This made a sudden and large increase in note-issue difficult for the Government, making the system of note issue inelastic The Commission recommended a larger amount of fiduciary issue

e rate of 1*s* $3\frac{29}{32}d$ per rupee whenever called upon to do so. may be recalled that during the crisis of 1907-08 they were ld only after considerable hesitation).

The report of the Commission was published in February 914 and in July 1914 the war broke out. The Government uld not, therefore, take action on most of the recommendaons of the Commission but they abolished the silver branch the Gold Standard Reserve and readily offered Reverse uncils for sale when the demand for them arose at the out reak of war

§ 3 War and Breakdown of Gold Exchange Standard

The outbreak of the war in July 1914 caused in India a neral dislocation of trade and business Exchange became eak,[1] savings bank deposits were withdrawn, notes were resented for encashment in large quantities and gold was emanded in exchange for notes All these were signs of panic nd the Government took speedy action in dealing with them.[2] o deal with the weak exchange, sterling drafts were sold to ne extent of £8,707,000 Demand for withdrawal of savings ank deposits was met by continuous payments and about ls 8 crores were paid within a few months Notes were eadily encashed to the extent of Rs 10 crores The demand or gold in exchange for notes was met in the beginning but the sue of gold to private persons (*i e* , apart from genuine trade urposes) was stopped on the 5th August, 1914 All these rompt measures led to the restoration of public confidence y the beginning of 1916

About the end of 1916, however, complications began to irise in the Indian currency system. The balance of trade began to turn abnormally in favour of India and during 1916-17, 1917-18, and 1918-19 the balance was much larger than the average pre-war balance This was due to two

[1] This always happens due to capital being withdrawn from the ountry in panic and a loss of confidence in the currency

[2] Fortunately the banking crisis of 1913-14 had already had 'the salutary effect of purging the country of unsound institutions whose collapse at a later stage would have greatly aggravated the situation' (*Report of the Controller of Currency* for 1913-14)

causes : (*a*) increase in exports due to demand at high prices for raw materials and foodstuffs required for the use of the Allied Powers and (*b*) contraction of imports from United Kingdom and her Allies and complete cessation of imports from Germany and Austria Owing to this favourable balance of trade, a tendency was set up towards a rise in the rate of exchange and there was a heavy demand on the Government for rupees and currency notes This heavy demand was further intensified by other payments that had to be made on behalf of the British Government, British Dominions and America for expenses of war in Mesopotamia, Persia etc , and for purchases made in India The Government of India would not have been called upon to meet this heavy demand all by themselves if gold and silver had flowed freely into India as in pre-war years Restrictions had, however, been imposed on the export of gold and silver by countries engaged in war and the world production of silver had also fallen. The burden of liquidating the balance of trade was thus thrown wholly on the Government

The large purchases of silver by the Government of India, in order to meet the additional demand for currency, combined with a decrease in the world supply of silver and the increased demand from other countries, led to a rise in the price of silver From 27¼*d* per standard ounce in 1915 the price of silver rose to above 43*d.* per standard ounce in August 1917 and 55*d* in September 1917 The price of 43*d* per standard ounce deserves notice because at this price the exchange value of the rupee was equivalent to its bullion value If the price rose higher than 43*d* per ounce, the exchange value of the rupee could not be maintained at 1*s* 4*d* The rupee became worth far more than this in gold and if the Government did not give more than 1*s* 4*d* in exchange for a rupee, the rupee itself would be melted or exported On the other hand, the Government could not continue to sell Council Drafts at the rate of 1*s* 4*d* *i.e*, give rupees, whose value was rapidly rising, in exchange for sterling at that rate With every rise in the price of silver above 43*d* , the government had to raise the rate of exchange accordingly The Gold Exchange Standard which depended for its satisfactory

ɔrkıng on the sale of Councıl Drafts without lımıt and on pee remaınıng a token coın broke down The exchange lue of the rupee now began to move ın step with ıts trınsic value as ıt had done from 1873 to 1893

The Gold Exchange Standard was an accidental find for dıa It was almost a case of Jupıter goıng out to find fire d findıng God. The system had receıved the praıse and proval of Mr J M Keynes and the Chamberlain Commis-ɔn India, they had seemed to say, had discovered a wonder-l standard which lay ın the "maın stream of currency olution"[1] India had been saved from the cruel fate of ıng crucified on the cross of gold She could well spread ɛr taıls lıke a peacock to the sun But now that the ındard broke down, 'the enchantment was at an end, the irage evaporated, the soap bubble burst and the charıot of Inderella relapsed ınto ıts orıgınal pumpkıns and mice!'

[1] J M Keynes *Indian Currency and Finance* p 29

CHAPTER V

. *IV Period August* 1917—1920

WARTIME REGULATION OF CURRENCY

§ 1 GOVERNMENT MEASURES TO REGULATE CURRENCY

In September 1917, the Government of United States took measures to control silver market and upto April 1919, the price of silver did not rise higher than *50d* per standard ounce When the control over the silver market was withdrawn in May 1919, the price began to rise again It rose to *58d.* per oz in May 1919 and to *78d* per oz. in December 1919. As the price of silver rose, the rate at which Council Drafts were sold had also to be raised. It was raised as follows—

28th August,	1917	*1s 5d*
12th April,	1918	*1s 6d*
13th May,	1919	*1s 8d*
12th August,	1919	*1s. 10d*
15th September,	1919	*2s*
12th December,	1919	*2s 4d*

To meet the demand for rupees, the Secretary of State for India purchased silver for coinage into rupees but the demand was so enormous that the ordinary market could not satisfy it and an approach had to be made to the Government of U. S A for sale of silver dollars in their reserve In April 1918, the United States Government passed the Pittman Act authorising sale of silver from their reserve and the Government of India purchased 200 million fine ounces of silver If this huge quantity of silver had not been received, there might have been a serious currency crisis in India and the convertibility of currency notes into silver rupees would have had to

e suspended[1].

Besides raising the rate of exchange and purchasing silver, he Government of India also took measures to exclude rivate buyers from the silver market, conserve their stocks of old and silver and to economise the use of silver From 3rd eptember 1917, the import of silver into India on private ccount was prohibited The melting of silver or gold coin vas made illegal in June 1917 and the export of silver coin nd bullion from India was prohibited in September 1917 Rs $2\frac{1}{2}$ and one-rupee notes were issued[2] and nickel coins f eight, four and two annas were put into circulation On 29th June 1917 an Ordinance was issued requiring all old imported into India to be sold to the Government Gold nohurs and sovereigns equivalent to 15 rupees were also oined and issued to supplement the currency The fiduciary portion[3] of the note-issue was increased from November 1915 onwards rising from Rs 14 crores in 1911 to Rs 120 crores in 1919 and restrictions were imposed on the encashment of notes This led to a small discount or *batta* on notes in many parts of the country.

§ 2 A POST-WAR REVIEW

The Babington Smith Committee, 1919

All these measures were taken to cope with an unforeseen situation of great difficulty. As the tension created by the war relaxed, restoration of stability in exchange became necessary

In May 1919, therefore, a Committee was appointed under the chairmanship of Sir Henry Babington Smith to examine the effect of the war on Indian exchange and currency system, to suggest modifications in it and to make recommendations

[1] At one time in the year 1918, the rupees in the Currency Reserve available for encashment of notes amounted to a little more than 4 crores against a total note circulation of 115 crores

[2] The issue of these notes was stopped from 1st January 1926

[3] The portion of note-issue not backed by metallic reserve but by securities

with a view to ensuring stable exchange standard These terms of reference precluded the Committee from considering or recommending any other system of currency.

The Committee emphasized the importance of stability of exchange for production and trade and recommended that the exchange value of the rupee be fixed at 2*s* (gold) *i e.*, Rs 10 . one Sovereign [1] Two points about this recommendation deserve notice . firstly, a high rate of exchange was to be fixed and, secondly, the value of the rupee was to be fixed in terms of gold rather than sterling. During the war, sterling, *i e* British paper money, did not remain equivalent to the gold it represented. It had depreciated in relation to gold. The Committee were in favour of linking the rupee to gold rather than depreciating sterling.

A high rate of exchange was recommended by the Committee to ensure that the rupee would remain a token coin. By making the rupee a token coin the Gold Exchange Standard could be made to function as before [2] The Committee favoured a high rate of exchange on other grounds also A high rate of exchange would secure imports of goods at lower prices or at least check the rise of prices and thus reduce social and economic discontent.[3] It would have no adverse effect on exports of Indian goods because of the large world demand for Indian raw materials and foodstuffs. It would help industrialists, too , for it would keep down the prices of imported stores and machinery and by keeping low the cost of living check a rise in the wages of the

[1] At this rate one Rupee=11 30016 grains of fine gold

[2] It may be mentioned here that the fixation of a high rate of exchange was not the only possible way of restoring the token character of the rupee Two other ways of achieving the same end were the debasement of the rupee coin (*i e* reduction in its weight or fineness) and the complete or partial suspension of the convertibility of rupee notes into rupee coin These were considered but rejected by the Committee on the weighty ground that they were in the prevailing state of public confidence impracticable.

[3] If the rate of exchange be 2*s* (gold) or Rs 10 to one sovereign 10 rupees, have to be paid for an imported commodity like cloth or sugar worth one sovereign , if the rate be lower, say, 1*s*, 4*d*, or 15 Rs £, the price paid is higher

workers Finally, it would secure an economy in Home Charges, for a given amount of them could be remitted with a smaller number of rupees

Mr D M Dalal, a member of the Committee, was opposed to the stabilization of the rate at 2s. (gold) and wrote a minority report He was in favour of maintaining the old ratio of 1s 4d. Re The rise in the price of silver was the chief argument for raising exchange ratio but Mr Dalal held that the rise in the price of silver was artificial and could have been prevented by allowing export of silver from India after the War. He also believed that a rise in exchange ratio would cause setback to several Indian industries and big losses to Indian exporters It would also involve enormous loss to India on account of revaluation in terms of rupees of reserves invested in sterling securities and of gold held as part of the metallic reserve against the note-issue Mr Dalal regarded Gold Exchange Standard as unsuitable to Indian conditions and was generally in favour of abolishing the control exercised by the Secretary of State over Indian exchanges and removing restrictions on the free movement of gold and silver bullion to and from India

The main conclusions and recommendations of the Babington Smith Committee may be set down as follows—

Those relating to stabilization of the Rupee

(*i*) It is desirable to restore stability of the rupee and to re-establish the automatic working of the currency system

(*ii*) The exchange value of the rupee should be fixed in terms of gold rather than sterling and stabilized at 2*s*. (gold) or Rs 10 to one sovereign (one rupee = 11 30016 grains of fine gold)

Those relating to restoration of automatic working of the system

(*iii*) Council Drafts may be sold by the Secretary of State in excess of his immediate needs when a trade demand for them exists

(*iv*) During periods of exchange weakness, the Government of India should be authorised to sell Reverse Councils without previous reference to the Secretary of State. Inconvenience and delay were caused by the necessity of consulting the Secretary of State beforehand and public confidence in the system was not ensured.

(*v*) The import and export of gold into and from India should be free from Government control.

(*vi*) The prohibition on the import of silver and import duty on silver should be removed as soon as convenient. The prohibition on the export of silver should be retained to prevent depletion of silver.

Those relating to use of gold currency

(*vii*) To encourage the increased use of gold in internal circulation would not be to India's advantage. Gold is best kept in Government reserves where it is available to meet demand for foreign remittance Gold coins may, however, be issued in moderate quantities and sovereigns may be coined and issued

(*viii*) The obligation of the Government to give rupees for soverigns should be withdrawn but opportunities should be given to the public when introducing the new ratio to exchange sovereigns in their possession at the rate of £1 Rs 15

Those relating to reserves

(*ix*) Profits on the coinage of rupees should continue to be credited to Gold Standard Reserve, the amount of which cannot yet be fixed The Reserve should contain a considerable proportion of gold, not more than one-half of the gold being held in India. The invested portion should continue to be held in London in liquid securities

(*x*) The metallic backing behind paper currency in the Paper Currency Reserve should be fixed by law at a minimum of 40 per cent of the gross circulation The maximum for fiduciary issue should be retained at Rs 120 crores for a

limited period The portion invested in Government of India securities should be limited to Rs 20 crores To meet the seasonal demand for additional currency, notes upto Rs 5 crores, over and above the fiduciary issue, may be issued as loans to the Presidency banks against export bills of exchange

(iv) The silver and gold in the Paper Currency Reserve should be held in India except for transitory purposes

CHAPTER VI

POST-WAR DEVELOPMENTS

(1920—1927)

§ 1. FAILURE OF THE GOVERNMENT ATTEMPT TO RESTORE STABILITY

V Period February 1920—*September* 1920

The recommendations of the Committee were accepted by the Secretary of State in February 1920, and various notifications were issued to give effect to them. It was notified that Council Drafts would be offered for sale at no fixed minimum rate and Reverse Council Drafts would be offered in future, if required, at a rate based on 2*s.* gold. Wartime restrictions on the import (but not export) of silver bullion, melting of silver coins and import and export of gold bullion and coin were removed. By the Indian Coinage (Amendment) Act of 1920 the sovereign was made legal tender at Rs. 10.

About the beginning of February 1920 a keen demand arose for remittances to London owing to an enormous increase in imports and a fall in exports. The anxiety of European businessmen to transfer their accumulated profits from India to London also added further to the demand Steps were at once taken to maintain the new exchange rate of 2*s.* (gold) by offering Reverse Councils at a rate based on the sterling equivalent of 2*s.* (gold) The sterling equivalent of 2*s* gold could be calculated only from the dollar sterling rate[1] As sterling was not equivalent to gold in England, its depreciation in relation to gold could be measured only from its ratio to dollar which was at par with gold. If the value of sterling in terms

[1] Often referred to as London-New York cross rate

of dollar fell, the sterling equivalent of 2*s* (gold) would rise and sterling-rupee exchange ratio based on 2*s* (gold) would also rise This may be made clearer by an example.

A definite quantity of gold = 4 8 dollars = one pound sterling = one sovereign = 10 Rs

If sterling depreciates by 50% in relation to dollar then,

The same quantity of gold = 4 8 dollars = 1 5 pound sterling = one sovereign = 10 Rs

As sterling depreciates, therefore, the same number of rupees begin to purchase a larger amount of sterling

In the beginning of February 1920, the cross rate fell and the value of the rupee in terms of sterling rose The Indian exporters fearing further rise began to sell their export bills This accentuated the tendency towards a rise and the market rate reached 2*s* 10⅝*d* (sterling) on 11th February 1920 After this, however, the sale of export bills fell off and the sterling value of the rupee began to fall. Three other forces began to operate to accentuate this tendency towards a fall—

(*i*) More rapid fall in the level of sterling prices than rupee prices [1]

(*ii*) Unfavourable balance of trade which commenced in June 1920

(*iii*) Fall in the price of silver, the prices in June 1920 being 44*d* per standard ounce

The Government tried to maintain the rate at first at 2*s* (gold), then from 24th June to 28th September 1920 at 2*s* (sterling), the market value of the rupee having fallen lower The Reverse Councils sold at the above rates were met by the sales of sterling securities and Treasury bills in the Paper Currency Reserve at prices much lower than those at which they were purchased The amount paid out of Paper Currency Reserve from the beginning of 1920 to the end of September was nearly £55 4 millions but the sterling value of the rupees purchased was only £25 millions The loss to the Indian exchequer caused by the ill-advised attempt to maintain the rupee at 2*s* amounted to Rs 40 crores The

[1] The British Government had begun to deflate currency with a view eventually to making sterling equivalent to gold

Indian importers who had ordered goods from abroad expecting to pay one rupee for every 2s. also suffered serious losses owing to the failure of the Government to maintain the rate They were also put to great hardship by the fall in prices and the rise in bank rate caused by the contraction of currency by the Government.[1] Many of them were driven to the verge of bankruptcy

§ 2 ABANDONMENT OF ATTEMPT TO MAINTAIN STABLE EXCHANGE

VI Period October 1920—1927

The Babington Smith Committee based their recommendation for the stabilisation of 2*s* rate on the wrong conjecture that the price of silver would continue to rule high for some time to come The conditions of the contemporary world were, however, much too uncertain and a wiser course for the Committee should have been not to recommend any definite exchange rate. In fact, they did say while examining the possibility of a large and rapid fall in world prices that if such a fall occurred ('contrary to expectation'), the maintenance of exchange at the proposed rate might be endangered "In that case it would be necessary to consider the problem afresh."[2] But otherwise, they were against the postponement of decision in this regard for three reasons first, they had been called upon to recommend measures for the restoration of a stable gold exchange standard and they did not want to shirk their responsibility , second, they did not consider stability unattainable , and third, they considered continuance of the existing uncertainty, involving as it did prolongation of Government control over currency, open to serious criticism [3]

The Government of India showed an extraordinary alacrity

[1] Currency was contracted to prop up the tottering exchange ratio When the supply of money in the market becomes less, the rate of loans rises Currency contraction lowers prices also

[2] *Report*, para 51 [3] *Ibid*, para 58

in taking action on the Committee's recommendation They could have waited a little longer

But even after the Committee had made its recommendation and the necessary action had been taken on it, it was open to the government to retrace their steps as soon as they found the new ratio untenable. They need not have prolonged an egregious blunder at a heavy cost

Eventually the attempt to maintain the rate at *2s* had to be abandoned At the end of September, the Government suspended entirely the sales of the Reverse Councils The intervention of the Government thereafter grew less but exchange was not left entirely to look after itself For some time, the exchange rate fluctuated from day to day according to the supply of and demand for exchange and at a time of general slackness in foreign trade, it was naturally particularly sensitive to the export and import of gold and silver bullion[1] The Government continued to effect some measure of currency contraction to attain some parity between internal prices and the falling world prices But as the world prices were falling rapidly, the adjustment took the form of a fall in exchange rather than a rapid and heavy fall in internal prices

In 1921 the balance of trade was still against India and the rate of exchange which had fallen to nearly 1*s* 5*d*. in December 1920, fell still lower to 1*s*. $2\frac{7}{8}d$ (under 1*s* gold) in March 1921 In 1922, the balance of trade began to turn favourable to India and the sterling value of the rupee rose till it reached its pre-war level—1*s* 4*d* sterling—in January 1923 From January 1923 to June 1924, the sterling rate moved between 1*s* $4\frac{1}{32}d$, and 1*s* $5\frac{7}{32}d$ the gold rate being more or less stable round 1*s* 3*d* (the limits being about 1*s* $3\frac{9}{32}d$ and 1*s* $3\frac{1}{2}d$[2] It rose to 1*s* 6*d* sterling (about 1*s* 4*d* gold) in October 1924 and the action of the Government was now directed towards preventing its rise above that rate After the end of May 1925 the rupee ratio was kept in the vicinity

[1] *Cf* Sir W M Hailey's Budget Speech for 1921-22

[2] Appendix 3 to the Report of the Royal Commission on Indian Currency and Finance, Vol ii p 33

of 1*s* 6*d.* gold.

A rise in exchange rate above 1*s.* 6*d* sterling was prevented by the Government by introducing the practice of purchasing sterling in India. The purchase of sterling *in India* has the same effect as the sale of Council Drafts *in London*, *i e*, sterling is given by banks and firms in London for credit to the account of the Secretary of State and rupees paid to them in India. The advantages claimed for the system of sterling purchases are the following—

(*i*) the initiative in making remittances of sterling to London is transferred to the Government of India to whom it should rightly belong.

(*ii*) the purchases of sterling can be regulated with reference to the conditions of the Indian exchange market and heavy fluctuations in exchange rate avoided

The system of purchase of sterling has gradually displaced since 1924 that of the sale of Council Drafts.

In pursuance of the recommendations of the Babington Smith Committee, changes were also made in the Acts governing the paper currency system. These were incorporated in the Consolidating Act of 1923, as amended in 1923 and 1925. The Act laid down permanent provisions for the regulation of paper currency but as the permanent provisions could be carried into effect only after some time owing to the aftermath of abnormal war conditions, certain transitory provisions were also laid down. The *permanent provisions* were—(*i*) the metallic portion of the Reserve was to be at least 50 per cent of the whole, (*ii*) the Government of India securities in the Reserve were to be Rs 20 crores in amount and of these, the created securities were not to exceed Rs 12 crores, (*iii*) the Governor-General-in-Council was empowered to issue currency notes upto Rs. 5 crores in amount against inland bill of exchange maturing within 90 days[1]. This additional issue of currency could be made on payment to the Government by the Imperial Bank of India of a rate not lower than 8 per cent. The amount

[1] This provision was introduced to make the note issue more elastic in order to meet the seasonal demand for currency

of extra note issue was raised from Rs 5 crores to Rs 12 crores by an Amending Act of 1923 and in 1924 it was laid down that of these, Rs 4 crores were to be issued when the Imperial Bank rate rose to 6 per cent and the remaining Rs 8 crores when it rose to 8 per cent The *transitory provisions* were (*i*) the amount of securities in the Reserve was to be Rs 85 crores (raised later to Rs 100 crores in 1925), (*ii*) the Government were authorised to create securities (ad hoc securities) and issue them to the Controller of Currency but the amount of securities was to be gradually reduced to Rs 12 crores—the maximum amount permissible under permanent provisions

CHAPTER VII

THE HILTON YOUNG COMMISSION

VI Period October 1920—1927 (*Contd*)

§ 1 THE RECOMMENDATIONS OF THE HILTON YOUNG COMMISSION

In April 1925 England returned to gold standard and 1*s* 6*d* sterling became equivalent to 1*s* 6*d* gold In August 1925 a Commission was appointed under the chairmanship of Mr Edward Hilton Young "to examine and report on the Indian exchange and currency system and practice, to consider whether any modifications are desirable in the interests of India and to make recommendations"

The report of the Commission was published in 1926 The three main recommendations of the Commission related to—

(*i*) the selection of a standard of currency

(*ii*) the establishment of an authority to control the currency

(*iii*) the rate at which the rupee should be stabilized

The Commission made the following recommendations—

(*i*) Gold bullion standard should be adopted as the system of currency Gold coins should not be introduced into circulation but an obligation should be imposed by law on the currency authority to buy and sell gold in the form of gold bars without limit in exchange for rupees and currency notes The legal tender quality of sovereigns and half-sovereigns should be removed There should be no legal obligation on the Government to give rupees for currency notes

(*ii*) The control and management of currency should be entrusted to a central bank (to be called the Reserve Bank of India)

(*iii*) The rate of exchange should be stabilized at 1*s* 6*d*

(*iv*) One rupee notes should be reintroduced and should be full legal tender[1] Notes other than the one rupee notes should be legally convertible into legal tender money, *i e*, notes of smaller denominations or silver rupees *at the option of the currency authority*.

(*v*) The Paper Currency Reserve and the Gold Standard Reserve should be amalgamated Not less than 40 per cent of the combined Reserve should consist of gold and gold securities

Sir Purshotamdas Thakurdas, a member of the Commission, wrote a minute of dissent in which he emphasized that the change from gold standard to gold exchange standard in the past was " in absolute contravention of the currency policy officially adopted in 1899, binding on the Government and the country " He, however, agreed with the gold bullion standard recommended by the Commission *provided there was no interference with the free inflow of gold into India except with due publicity and the concurrence of the legislature* He was of opinion that the demonetisation of sovereign and half-sovereign was unnecessary

As regards a central bank he held that in the special conditions of India, the ends in view would be better served by developing the Imperial Bank of India into a full-fledged central bank If, however, the shareholders of the Imperial Bank did not agree to a restriction of their dividends, there would be no alternative left but to start a new central bank

As to ratio he disagreed that 1*s* 6*d* ratio was the *de facto* ratio and that prices, wages and finance had adjusted themselves to it He recommended that the rupee should be stabilized at the rate which prevailed for nearly 20 years, *viz*, 1*s* 4*d* to the rupee

The conclusions and recommendations of the Hilton Young Commission relating to currency standard, currency authority and exchange rate gave rise to acute controversy These may be examined further in the next three sections

[1] See p 39, footnote 2

§ 2. THE PROBLEM OF A MONETARY STANDARD FOR INDIA

A sound monetary standard must satisfy certain essential requirements, such as simplicity, certainty and stability and the suitability of the standard must be judged by the extent to which it satisfies them The Hilton Young Commission had to select a standard that would meet these requirements The choice had to be made out of four possible standards—

(*i*) the pre-war sterling exchange standard in a perfected form, *i e.*, with its defects removed.

(*ii*) Gold exchange standard.

(*iii*) Gold standard with gold currency

(*iv*) Gold standard without gold currency or gold bullion standard.

The Commission rejected the first three alternatives and recommended for adoption gold standard without gold currency

Gold Exchange Standard A Critique

The standard which worked in India from about the beginning of the present century to 1917 was in fact sterling exchange standard Under it Indian currency was convertible into sterling but so long as pound sterling was convertible into pound gold, it was as good or as bad as gold exchange standard. This standard worked fairly well and secured stability of exchange for about fifteen years. It had the merit of being cheap because gold did not circulate as currency. It had however, certain serious defects which may be described as follows .—

(*i*) It was not simple and intelligible to the people. The internal currency consisting of rupees and currency notes was not convertible into anything tangible and visible (such as gold) It was convertible into sterling for making payments outside the country on those rare occasions when the balance of trade turned against India The working of the standard involved a good deal of government control and inter-

ference and this did not inspire confidence in the minds of the people[1]

(ii) It had resulted from a series of administrative notifications It was not subject to any statutory regulation or control but depended for its working on a policy of the Government There was, for example, no statutory obligation on the Government to sell Reverse Councils by which the rate of exchange was prevented from falling below 1*s* 4*d* The standard had thus no definite legal basis

(iii) It depended for its satisfactory working on rupee remaining a token coin If the price of silver rose above a certain point, the intrinsic worth of the rupee became greater than its exchange value and it became profitable to melt it or export it The standard was thus subject to the danger of rupee disappearing from circulation It broke down in 1917 when the gold price of silver rose above 43*d* per standard oz.

(iv) It was a dependent standard because under it the internal currency was linked not to gold but to the currency of a foreign country It was thus exposed to the currency and credit changes in England As the Hilton Young Commission remarked, " there is undoubled disadvantage for India in dependence on the currency of a single country, however stable and firmly linked to gold."

(v) It was not automatic in its working because the sale of Councils and Reverse Councils did not lead to an automatic expansion and contraction of currency The expansion and contraction were regulated by the Government In 1919-20-1921, for example, Reverse Councils of the value of more than £55 millions were sold and under an automatic system, internal currency of the value of about Rs 47 crores would have been withdrawn from circulation But the actual contrac-

[1] " However complete the integrity and however great the intelligence on which official action is based, an automatic system which does not depend upon such action for its operation, is greatly to be preferred "—*Babington Smith Committee s Report, para 35*

' We believe that a pure exchange standard is no more and no less liable to manipulation than a gold standard, but that is not the opinion of the Indian public, and it is essential that whatever system of currency is adopted should be one that is capable of securing the confidence of Indian public opinion "—*Hilton Young Commission's Report, para 30*

tion amounted to only to a little over Rs. 34 crores Similarly when Council Bills were sold, currency was not expanded to the same amount

(vi) It was not elastic, i.e, it did not make a satisfactory provision for an increase in currency in busy seasons and times of financial crisis When crops have been harvested and are moved, there arises an increased demand for currency but under the pre-War system this could not be properly satisfied[1] Nor was there any provision for an emergent issue of currency

(vii) The two reserves—the Gold Standard Reserve and Paper Currency Reserve—which were kept to maintain the value of token currency were governed in practice by transitory provisions Their functions also were confused and there was overlapping of the purposes for which they were maintained The original function of the Paper Currency Reserve was to provide for the convertibility of notes into rupees and that of the Gold Standard Reserve was to maintain the external value of the rupee In practice, however, the Reserves were used indiscriminately to maintain the external value of the rupee and notes There was also duality in the control of currency and credit policy

Most of these defects were pointed out by the Commission who concluded that an exahange standard whether based on sterling or gold would not remedy the defects of the Indian currency system

Pros and Cons of Gold Standard with Gold Currency

Gold standard with gold currency had been demanded by the Indian commercial opinion as far back as the middle of the last century and the demand had been reiterated many t

[1]Currency could be expanded only by sale of Council Bills which would be demanded when goods were exported There was no provision by which currency could be expanded to meet the demands of internal trade The following passage occurs in the evidence of Lord Inchcape who was for some years the chairman of the Finance Committee of the Secretary of State's Council, before the Chamberlain Commission —

Mr J M Keynes ' But there is no means by which the amount of currency in India can be increased from within India, as is the case in every civilised country in the world ? "

Lord Inchcape ' There is no means

(*Minutes of Evidence*, Vol II, p 101)

time since then The Fowler Committee recommended in 1898 a close approximation of gold standard with gold currency with a view to the "effective establishment in India of a gold standard and currency based on the principles of free inflow and outflow of gold" That aim was gradually deviated from and gold exchange standard came to be adopted The Chamberlain Commission (1913) were not in favour of introducing gold currency but they conceded that "if Indian sentiment demands it and the Government of India are prepared to incur the expense," a mint for the coinage of sovereigns may be established, adding that "it is pre-eminently a question in which Indian sentiment should prevail" The Babington Smith Committee (1919) were precluded by their terms of reference from recommending any standard other than gold exchange standard When the Hilton Young Commission was appointed in 1925, the question of a suitable standard for India came once again into prominence

The officials of the Finance Department of the Government of India submitted to the Hilton Young Commission a scheme for the introduction of gold standard with gold currency The scheme assumed that the management of paper currency and the conduct of Government remittances to London would be transferred to the Imperial Bank of India The main features of the scheme were as follows—

(i) Gold coins and bank notes to be unlimited legal tender Rupees to remain unlimited legal tender in the beginning but after some years to be made limited legal tender up to Rs 50 only

(ii) A statutory obligation to be imposed on the Government to give gold coin in exchange for gold bullion

(iii) Bank notes to be payable on demand in gold coin

(iv) A statutory obligation on the Bank to buy gold

(v) A Reserve containing a certain percentage of gold and securities (gold and sterling) to be maintained

(vi) The Imperial Bank to supply funds to the Secretary of State for meeting Home charges

This scheme was to be introduced gradually over a period of about 10 years It involved the sale of a large quantity of silver and the purchase of gold to the extent of about £103 millions

The Commission rejected the scheme and the objections they raised against it are the main objections that might be raised against any proposal to introduce gold standard and currency in India The grounds on which the scheme was rejected may, therefore, be stated

Objections to the scheme of gold standard with gold currency

(*i*) " A large extra demand (for gold) from India would cause increased competition for gold among the countries of the world and lead to a substantial fall in gold prices and a substantial curtailment of credit " India in common with other countries would suffer from such fall in prices and curtailment of credit [1]

(*ii*) The amount of gold that would be required for ensuring convertibility of notes and rupees cannot be accurately estimated. For it is possible that people may begin to prefer gold coins to notes and to that extent notes would be replaced by gold coins The fear of a fall in the status of the rupee may similarly bring out a huge number of rupees for conversion into gold coins The actual demand for gold may thus turn out to be much greater than the estimated demand.

(*iii*) The fall in the demand for silver due to the adoption of gold standard would depress the price of silver This would not only involve the sale of surplus silver at a low price but would also lower the value of the savings of poorer Indian people who invest their savings in silver ornaments

[1] Gold is the basis of credit because in countries whose currency is convertible into gold it is the backing behind the paper currency in circulation If India purchased large quantities of gold to maintain them as a backing behind its paper currency the demand for gold would increase A rise in the demand for gold would raise its price in terms of commodities, *i e*, more of commodities would be given to get a certain quantity of gold In other words the prices of commodities, in terms of gold would fall A fall in prices would lead to depression in trade and India as a unit in the world trade system would suffer An increased demand for gold from India would also mean that there would be less of gold, available for other countries as a backing behind their paper currencies This may necessitate contraction of paper currency with a view to maintain its convertibility into gold And this would involve contraction of credit

(*iv*) The adoption of gold standard by India might lead to demonetization of silver by China also This would raise the price of gold and depress the price of silver still further In any case, the exchanges with China would be dislocated by any fall in the price of silver, China being a silver standard country. This would affect adversely trade with China, 'the only great, undeveloped market left for the expansion of international trade'

(*v*) It would not be easy to obtain the large amounts of gold without the co-operation of Great Britain and U S A and both the countries viewed with alarm the prospect of a large demand for gold from India in asmuchas it would upset world prices

(*vi*) The scheme would prove costly and though the cost could not be estimated accurately, it would be considerable It might be in the neighbourhood of Rs 3 crores a year for about ten years.

To these objections of the Commission may be added a few others which apply to gold standard and currency in general (rather than to any particular scheme of it)

(*vii*) Gold currency standard is expensive in that it involves the circulation of a very costly metal as currency It would be better by far that gold should remain in the reserves to lend stability to exchange

(*viii*) Gold currency is " a sign of backward civilization" and an "obsolete ideal" Many countries which returned to gold standard after the last War did not introduce gold currency

(*ix*) The bulk of internal transactions in India involve small payments for which rupees rather than gold coins are required by the people Gold coins will therefore be of no use unless they are of very small value

As there has been an insistent demand in this country for gold standard with gold currency, it is necessary to know the reasons for which it was favoured

Merits of Gold Standard with Gold Currency

(*i*) Gold standard with gold currency is an automatic standard and prevents undue government interference with

currency and exchange. Under it the inflow and outflow of gold are free and by producing their reaction on prices set into operation the natural correctives to fluctuating exchange [1]

It is however, difficult to say if the standard would work automatically in India If the imported gold is hoarded by the people and thus 'sterilised', prices may not rise and if gold does not come out of circulation for being exported when the balance of trade is against India, prices may not fall [2] The natural correctives to exchange will not then operate This is, however, on the assumption that the hoarding habit of the people will persist even after the introduction of gold currency.

(*ii*) The introduction of gold currency would discourage the uneconomic habit of hoarding gold It would make the rural masses familiar with gold coins and hold out the assurance that all other forms of currency being convertible into gold are as good as gold

The Hilton Young Commission differed from this view and held that " the mere act of putting gold into circulation would not develop the banking and investment habit" What was needed, they said, was confidence in the stability of currency

(*iii*) Gold standard with gold currency would inspire confidence of the people because the backing behind currency would be visible and tangible, much more so than under any other form of gold standard.

[1] When exports exceed imports the rate of exchange tends to rise and gold begins to flow into the country Normally the gold will be handed over to the currency authority in return for internal currency The consequent expansion of currency will result in raising internal prices The rise in prices will make the country a good market to sell goods in and a bad market to buy goods from, thus increasing imports and checking exports The initial tendency towards a rise in exchange rate set up by an excess of exports over imports will thus be arrested A similar corrective will begin to operate if exchange tends to fall due to the excess of imports over exports

[2] "All experience goes to show that, so long as the public have the option of making payments in tokens or in gold, it is the surplus tokens and not the gold in circulation which will seek an outlet at a time of weak exchange" —*Chamberlain Commission s Report, para 62*

(iv) The Indian people do want gold in circulation, as is evident from the large absorption of imported sovereigns from 1900 to 1914[1] Besides, the 'weight of good academic opinion' is in favour of gold currency and 'this is pre-eminently a question in which Indian sentiment should prevail.'

(v) Gold currency is a stage in currency development towards an ideal system under which currency would be convertible into gold but gold coins will not circulate on any appreciable scale India will have to pass through this stage[2]

Gold Bullion Standard as recommended by the Commission

The Commission recommended gold bullion standard, as they called it, for adoption by India The main features of the standard were the following—

(i) An obligation was to be imposed on the currency authority to buy and sell gold at a certain fixed rate and in quantities of not less than 400 fine ounces (= 1065 tolas) In other words, the rupees and currency notes were to be made convertible into gold bars weighing not less than 400 fine ounces There was to be no limitation as to the purpose for which gold was required but the conditions as to the sale of gold were to be so framed that normally the currency authority would not be called upon to supply gold for non-monetary purposes

(ii) Sovereign and half-sovereign were not to remain legal tender,[3] but the rupee was to continue to be full legal tender

[1] It is of interest to note that in 1911-12 and 1912-13 the Comptroller General and the Head Commissioner of Paper Currency made special enquiries to find out the actual use to which sovereigns were put by the people and the Accountant General, Punjab who made detailed enquiries in 1911-12 reported that the popularity of the sovereign as currency is greatly on the increase and there is practically no part of the Punjab or Frontier Province where it is not eagerly sought after and accepted' Similar reports were received from other parts of India *Report of Comptroller General*, for 1911-12 pp 14—21, 1912-13 pp 22—26 and 1913-14 Appendix III

[2] Sir Basil Blackett s address before Delhi University in 1926 para 15

[3] They were made legal tender by the Act No XXII of 1899 (see p 26) Their demonetization was necessary to secure automatic contraction and

(*iii*) Government Savings Certificates were to be issued to bring home to the masses that gold was the standard of value and that gold and rupees were mutually convertible People could purchase these certificates and invest their savings in them After three or five years, they could receive the principal along with the interest in rupees *or* gold *at their option*.

(*iv*) The existing currency notes were to remain convertible into rupees but the new notes to be issued were not to be legally convertible into rupees Facilities for conversion of currency notes into rupees were, however, to continue to be provided

(*v*) One rupee notes which would be full legal tender but not legally convertible into rupees were to be issued

(*vi*) Gold Standard Reserve and Paper Currency Reserve were to be amalgamated.

The effect of the adoption of this system would be that (*a*) internal currency would consist of tokens—rupees and currency notes and (*b*) currency notes would not be convertible into rupees but both currency notes and rupees would be convertible into gold bullion.

Many advantages were claimed for the system by the Commission *Firstly*, it would secure stability of exchange by ensuring convertibility of currency into gold at a fixed rate *Secondly*, it was simple and certain because the backing behind the currency was one of gold into which internal currency would be convertible It would, therefore, inspire confidence of the people *Thirdly*, it was automatic because currency would be expanded when gold bars were given to the currency authority to obtain notes or rupees and would be contracted when notes or rupees were given to the currency authority to obtain gold bars *Fourthly*, gold would remain in the reserves and costly gold currency would not be introduced into circulation. *Fifthly*, it would pave the way for the introduction of gold currency at some future date if it was thought desirable to do so Gold currency could be introduced when sufficient gold had accumulated in the Reserves.

expansion of currency Gold coins in circulation by taking the place of rupees and notes would prevent the automatic working of gold bullion standard

The gold bullion standard recommended by the Commission was not full-fledged gold standard. The backing behind internal currency was not very tangible for ordinary people. Only bankers and bullion brokers could take advantage of the facilities for obtaining gold bars of 400 fine ounces [400 ounces = 1065 tolas = Rs 23,000 (approximately) at the price proposed to be fixed] The device of the sale of Savings Certificates was, therefore, recommended by the Commission for bringing home to the people the change in the previous system The conditions laid down for the sale of gold were such that gold would not be demanded by the people from the currency authority at all Owing to certain difficulties pointed out by the Commission,[1] gold currency standard could not be adopted forthwith Under the circumstances, the gold bullion standard though not conforming to the proper definition of gold bullion standard[2] was not an unsatisfactory system to be adopted and worked

§ 3 THE QUESTION OF A MONETARY AUTHORITY

The Hilton Young Commission found unsatisfactory the existing system of monetary control under which the Government controlled the currency and the credit was controlled, in as far as it was controlled at all, by the Imperial Bank This divided control of currency and credit prevented co-ordination of currency and credit policies It also kept the banking and currency reserves of the country separate, thus diminishing their capacity to be used in the most effective manner for the stabilisation of exchange

To bring about unity of policy in the control of currency and credit, the Commission recommended the establishment of a central bank, to be called the "Reserve Bank of India" It was to be a shareholders' Bank with a capital of Rs 5 crores Its management was to be conducted by a Central Board consisting of 14 members of whom 5 (including the

[1] The most important being the opposition of Great Britain and U S A
[2] See B R Shenoy's article in *The Indian Journal of Economics*, October 1933

Managing Governor and Deputy Managing Governor) were to be nominated by the Governor General-in-Council To eliminate the danger of any political influence, no member of Governor General's Council, Provincial Governments and Central and Provincial Legislatures was to be appointed President or Vice-President of a Local Board of the Bank or nominated as a member of the Central Board. The representatives of the commercial banks were to be ineligible in the same manner.

The proposed Reserve Bank of India was to perform all the functions of a central bank. It was to make and issue banknotes, receive deposits from and collect money for Central and Provincial Governments, banks and bankers and give loans to and make remittances on behalf of the Central and Provincial Governments It was to maintain the external and internal stability of purchasing power of the rupee It was to buy and sell gold at a fixed rate in quantities of not less than 400 ozs By taking over the remittance operations of the Government, the bank was to displace the Government from the exchange market It was to take over the management of Gold Standard Reserve and Paper Currency Reserve (which were to be amalgamated into one) and pay a share of its profits to the Government of India Finally, it was to act as bankers' bank

The Reserve Bank of India was thus to be the monetary authority to work the gold bullion standard recommended by the Commission

The Commission were against entrusting central banking functions to the Imperial Bank of India which in their opinion had useful work to do in extending commercial banking facilities in the country Sir Purshotamdas Thakurdas who wrote the Minute of Dissent held, however, that the Imperial Bank would not be hindered in its commercial business if i was entrusted with central banking functions He though that the proposed Reserve Bank would be a rival institution to the Imperial Bank and recommended the evolution of the Central Bank from the Imperial Bank. If, however, the shareholders of the Imperial Bank were opposed to their rights being restricted in the matter of getting their

dividends, there would be, he said, "no alternative left but to start a new Central Bank"

§ 4 THE RATIO QUESTION

The Hilton Young Commission considered the time fully ripe for the stabilisation of the rupee and recommended that the rupee be stabilised forthwith in relation to gold at a rate corresponding to an exchange rate of 1*s* 6*d* for the rupee The value of the rupee, they said, should be fixed in terms of gold and the rupee should be equivalent to 8 47512 grains of fine gold [1]

The Commission pointed out the advantages of adopting 1*s* 6*d* ratio as well as the disadvantages of reverting to the pre-war 1*s* 4*d* ratio The arguments given by the Commission *in favour of* 1*s*. 6*d*. *ratio* have been set down below

1 At the existing (1*s* 6*d*) ratio,[2] prices in India "have attained a substantial measure of adjustment with world prices and any change in the rate would mean a difficult period of readjustment, involving widespread economic disturbance" Since June 1925, exchange had been steady and the rupee prices and world prices had been falling together, showing that adjustment between exchange and prices had taken place. This conclusion was further confirmed by the absence of any adverse reaction on Indian trade

2 Wages also have adjusted themselves to the prices at the existing exchange rate of 1*s* 6*d* Though there is depression in jute industry and cotton mill industry, it is due to causes which the manipulation of exchange rate cannot remedy

3 As regards contracts, least injury will be caused by adhering to 1*s* 6*d* ratio It is true that land revenue and other long term contracts were settled when the ratio was 1*s* 4*d*, but owing to the rise of prices since 1914, the incidence of land revenue as calculated in terms of commodities has become lighter The contracts concluded after 1918 could not

[1] One gold pound contains 113 0016 grains of fine gold 8 74512 grs = 3/40 of gold pound=1*s* 6*d* (gold)

[2] The exchange rate had been 1*s* 6*d* (gold) since June 1925

have been on the basis of 1*s* 4*d* rate which was effective only for a very short period after 1918. As most of the contracts must be short term contracts, least injury would be done by adopting 1*s*. 6*d* ratio.

The Commission gave the following *arguments against reverting to 1s. 4d. ratio*

1. Though 1*s*. 4*d*. rate has been described as the 'natural' rate, it is difficult to understand in what sense it can be so described. If the Indian exchange were left to itself, there would be wide fluctuations in it and it would be impossible to find out the 'natural' rate.

2. 1*s*. 4*d* rate would not be easier to maintain in times of adverse balance of trade, as has been argued by its supporters[1] If the reserves are adequate as they would be, 1*s*. 6*d*. ratio can be made as effective as 1*s* 4*d*. ratio.

3 It has been suggested that the stabilisation of the rupee at 1*s* 4*d*. (Rs. 15 = one pound gold) will raise the price of gold and check the abnormal import of gold into India for being hoarded. But the import of gold is due to causes (such as the people's appetite for gold) which cannot be removed merely by adopting a lower ratio.

4 It is argued that if world prices fall in future, 1*s*. 4*d*. rate will cause less rapid fall in Indian prices than 1*s* 6*d* rate. But any abnormal price fall in future is not expected and any prolonged fall in prices will react on Indian price level whether the rate is 1*s* 4*d*. or 1*s*. 6*d*

5. 1*s*. 4*d*. rate was not effective from 1917 to 1925 and it cannot be contended that there has been an adjustment of prices and wages to that ratio. As there has been no such adjustment to 1*s* 4*d*. rate, the fixing of this rate will lead to profound disturbance in economic conditions. It will lead to a rise in prices, causing hardship to consumers and wage-earners It may also by raising cost of living lead to a demand for higher wages and salaries

6. The reversion to 1*s*. 4*d*. ratio will upset the finances of the Government of India Increased taxation may become

[1] The argument probably was that at 1*s* 4*d* ratio, less of gold would have to be given out of the reserves in return for a rupee when the internal currency was converted into gold

necessary to meet the sterling obligations of the Government If the budgetary equilibrium is upset, the credit of India as regards borrowing may also be impaired

The Minute of Dissent

Sir Purshotamdas Thakurdas dissented from the conclusions and recommendations of his colleagues in favour of 1*s* 6*d* ratio His *arguments against* 1*s*. 6*d* *rate* have been summarised below

1 The Government of India had been aiming at 1*s* 6*d* rate and, therefore, instead of stabilising the ratio at 1*s* 4*d* gold in September 1924, as they ought to have done, they contracted currency, or unduly limited its expansion, to push up the value of the rupee to 1*s* 6*d* 1*s* 6*d* rate had thus been secured by currency manipulation and was not a "natural" rate

2 There had been no adjustment of Indian prices since the rupee touched 1*s* 6*d* gold in June 1925 Though Indian prices had fallen since June 1925, the fall had been in response to a fall in world prices and not due to an adjustment of rupee prices to the higher (1*s* 6*d*) rate The full adjustment of rupee prices to 1*s* 6*d* rate was yet to come If world prices fall lower as is expected, the fall in Indian prices would be accentuated because, besides the adjustment already due, further adjustment would become necessary This heavy fall in prices will hit Indian producers very hard

3. There had been no adjustment of wages to 1*s* 6*d* ratio and such adjustment if it has to be enforced by lowering wages, "will entail a long and bitter struggle between Labour and Capital, with consequent disturbance in the economic organisation of the country"

4 Until wages get adjusted to 1*s* 6*d* rate—which will involve a long and painful process—the foreign manufacturers will enjoy a bounty of 12½ per cent[1] This indirect help to the foreign manufacturers will intensify competition with Indian industries

[1] At 1*s* 4*d* rate, a foreign article selling for Rs 15 in the Indian market will give to the foreign manufacturer one pound At 1*s* 6*d* rate, the same article worth Rs 15 will give him 12½ per cent more

5 It has been argued that 1s. 6d rate has had no adverse influence on Indian trade In respect of exports, the absence of adverse influence is due not to the suitability of the rate but to successive good harvests and the low holding power of the Indian agriculturist (who must sell and export his produce in any case) As regards imports there has been slackness in the demand for imports—an indication of lower purchasing power of the masses—and it is due to 1s 6d rate

6 The adoption of 1s 6d rate will be injurious to the debtor class There is no justification for imposing an additional burden on a class already overburdened

Sir Purshotamdas Thakurdas rested his *case for reversion to 1s 4d rate* on the following arguments —

1 1s 4d. rate had been in force for about 20 years and it should not be changed unless it is absolutely unmaintainable or unattainable

2 It will have no adverse influence on Indian finances because the loss in sterling remittances will be made up in other directions In any case, the gain in respect of sterling remittances obtained from 1s 6d ratio will be at the expense of the producer who will have to accept fewer rupees for the produce he has to sell

3 It will cause no hardship to those whose contract were entered into before 1917 and they include the vast mas of Indian agriculturists whose interests deserve full consid eration

4 The adoption of 1s 4d rate will appreciably diminis the risk of a depletion of the reserves in times of an advers balance of trade

5 No other country, even in the most prosperous cir cumstances, has considered it just or advisable to adopt a rat of exchange higher than its pre-war rate India also shoul revert to pre-war rate and thus establish public confidence in its currency system

Sir Purshotamdas Thakurdas having ably put forward hi case in favour of 1s 4d concluded on a note of apprehensio saying that if 1s. 6d ratio was accepted, "India will be face during the next few years with a disturbance in her economi

organisation the magnitude of which it is difficult to estimate but the consequences of which may prove disastrous "

§ 5. GOVERNMENT ACTION ON THE COMMISSION'S REPORT

The publication of the Commission's report in 1926 gave rise to strong controversy which centred for the most part round 1*s* 6*d* ratio Steps were taken by the Government to give effect to all the three main recommendations of the Commission

In January 1927, the Government introduced the "Gold Standard and Reserve Bank of India" Bill to give effect to the recommendations relating to the adoption of gold bullion standard and the establishment of the Reserve Bank of India The Bill was referred to a Select Committee There was a stout opposition by a majority in the Committee to the main features of the scheme incorporated in the Bill, that is, to the bank being a shareholders' bank and to the exclusion of members of legislature from its directorate The majority of the Select Committee also wanted an Indian as the Governor or Deputy Governor of the Bank and recommended the coinage of gold mohars Owing to differences between the Government and the opposition particularly on the question of directorate, the Bill was dropped finally in February 1928 So neither the Reserve Bank of India could be established nor gold bullion standard adopted

To give effect to the Commission's recommendations relating to the stabilisation of 1*s* 6*d* ratio, the Currency Act of 1927 was passed The Act established 1*s* 6*d* (gold) ratio[1] by imposing statutory obligation on the Government (1) to purchase gold at Rs 21-3-10 per tola in the form of bars containing not less than 40 tolas (15 ozs) of gold and (2) to sell gold for delivery at Bombay *or* sterling for delivery in London in amounts of not less than 1,065 tolas (400 ozs) of fine gold (or the equivalent amount of sterling) The Controller of Currency had the option to sell either gold or

[1] An amendment to fix the ratio at 1*s* 4*d* was lost in the Indian Legislative Assembly by 65 votes against 68

sterling The Act demonetized sovereigns and half sovereigns[1] but an obligation was placed on the Government to receive them at Currency Offices and Treasuries at their bullion value at the rate of 8 47512 grains of gold : Re.

The Act did not at all introduce gold bullion standard because the Government retained and actually exercised the option of selling, in return for internal currency, sterling for delivery in London Strictly speaking, therefore, the standard adopted was sterling exchange standard But so long as sterling was convertible into gold (as it was upto September 21, 1931) the standard was actually gold exchange standard. In a way, therefore, gold exchange standard, criticised and discarded by the Hilton Young Commission, was resumed

[1] See page 59, footnote 3

CHAPTER VIII

VII Period 1927—September 1931

ADJUSTMENT AND STRAIN

§ 1 PERIOD OF ADJUSTMENT (1927—SEPTEMBER 1929)

From 1st April 1927, when the Curreny Act of 1927 was brought into force to September 1929, trade conditions in India were generally favourable, both exports and imports registering a rise

Value of merchandise (including Government Stores)
(In crores of rupees)

	1926-27	1927-28	1928-29	1929-30	1930-31
Exports	311	330	339	319	226
Imports	241	261	263	250	173
Total value	552	591	602	569	399

The total value of exports and imports in the three previous years *i.e*, 1923-24, 1924-25 and 1925-26 was 600, 653 and 623 crores of rupees respectively[1] The improvement in trade need not be attributed to the stabilization of 1*s* 6*d* ratio, it might have been in a large measure the counterpart of much

[1] As prices of the articles of export and import vary from year to year the course of trade is better shown by the following table made on the basis of declared values in 1913-14 —

Values of exports and imports on the basis of declared values in 1913-14
(In crores of Rs)

	1923-24	1924-25	1925 26	1926 27	1927-28	1928-29	1929-30	1930-31
Exports	240	250	246	228	248	260	263	235
Imports	120	137	143	156	181	190	189	157
Total value	360	387	389	384	429	450	452	392

greater improvement in world trade Perhaps a lower ratio would have communicated that improvement to Indian trade in greater measure.

The Calcutta Index Number of prices, however, showed a noteworthy decline

July 1914=100

Year	Index No
1926	148
1927	148
1928	145
1929	141

The exchange, in spite of temporary recovery now and then,[1] showed signs of weakness for the most part of this period The measures taken by the Government to strengthen it were .—

(i) Raising the rate at which it was prepared to lend emergency currency to the Imperial Bank of India.

(ii) Sales of treasury bills in large amounts to prevent the outflow of funds

(iii) Contraction of currency.

§ 2 PERIOD OF STRAIN

(OCTOBER 1929—SEPTEMBER 1931)

After September 1929, India became involved in the world trade depression—a depression unprecedented in magnitude and intensity. The prices of both agricultural and manufactured goods began to fall, but the decline in agricultural prices was much heavier[2] Indian exports therefore received a severe setback The Indian exchange became definitely weak and the Civil Disobedience movement started in 1930

[1] It was strong from December 1927 to February 1928 and during October and November 1928

[2] From September 1929 to September 1931 the prices of exported articles fell by about 46 per cent and of imported articles by about only 17 per cent.

weakened it further by paralysing trade and industrial production and causing a flight of capital from India

The Government issued Treasury Bills in large amounts and contracted currency by selling sterling[1] and meeting these sales by transfers from the Gold Standard Reserve and Paper Currency Reserve to the Treasury balances of the Secretary of State

The measures taken by the Government to maintain 1*s* 6*d* ratio created stringency in the money market[2] and accentuated the fall in prices Strong protests against them were made by Indian commercial interests

§ 3 RATIO IN RETROSPECT

During the twenty years that fell between the two wars, the ratio question dominated Indian monetary thought almost continuously At times it began to appear as if the economic system of India was suffering from the cancer of a wrong ratio which was leading by painful degrees to a state of complete collapse Both the proponents and opponents of 1*s* 6*d* hotly pursued their arguments during the fateful years of 1925-27 For a year or two after the legalisation of 1*s* 6*d* in 1927, the controversy appeared to subside but the onset of depression released a fresh spate of accusations, arguments and counter-arguments After the eventful year of 1931, the ratio controversy grew livelier still, though it changed somewhat in form It will be convenient to review briefly the main issues of the controversy upto 1931 at this stage and defer their examination subsequent to that date to the next chapter

A careful perusal of the available contemporary accounts of the ratio controversy shows that the criticism of Government's exchange policy after the 1920 episode was directed

[1] From June to September 1931 Reverse Councils worth £14 millions were sold From 1926-27 to September 1931 currency of about Rs 138½ crores was withdrawn from circulation

[2] The financial year 1928-29 opened with 7 per cent bank rate After a drop of 2 per cent by November 1928 it rose to 7 per cent in December 1928, and to 8 per cent in February 1929 (See the article by J C and H Sinha in the *Sankhya* December 1938)

mainly along two lines. The first line of criticism was that the Government did not avail themselves of the opportunities that came in and after September 1924 to stabilise the rate at *1s. 4d* The contention here was that the Government did not intend to fix the rate at *1s 4d* and wanted to leave the question open The unwillingness of the Government to remove the dead and ineffective ratio of *2s.* from the statute book was cited in support of this contention. It is necessary in this connection to recount a few events in chronological order In January 1921, Sir Vithaldas Thackersey moved a resolution in the Central Legislature asking for a revision of *2s.* ratio but the resolution was opposed by the Government and was lost[1] In September 1924, a suggestion was made in the Legislative Assembly for the stabilisation of the ratio at *1s. 4d* (gold) but it was opposed by the Government[2] In January 1925 the Assembly passed a resolution recommending the appointment of a Committee with a majority of Indian non-officials on it and with an Indian chairman to examine the whole question of exchange and currency In February 1925 two Bills were introduced by Sir Purshotamdas Thakurdas to amend the Indian Coinage Act, 1906 and Indian Paper Currency Act, 1923, the common purpose of the two Bills being the fixation of the rate at *1s. 4d* gold[3] It would appear from this that the Government did not wish to fix the value of the rupee at *1s 4d* gold or any other rate but wanted to wait until the economic and monetary situation had become sufficiently clear to enable them to make up their mind They must have been naturally watching the developments in England where by a steady deflationary process the old gold parity of the pound was being gradually approximated to and they might have been reluctant to commit themselves to any course of action in advance The second line of criticism of Government's exchange policy was that the Government deliberately raised the ratio from *1s 6d* sterling (or *1s. 4d* gold) to *1s. 6d* gold by resorting to considerable deflation between June 1924

[1] Sir Purshotamdas Thakurdas's speech, *Leg Ass Debates*, 1927 Vol. 2, p 1797

[2] *Leg Ass Debates*, 1924, Vol 4, pp 3808-12

[3] *Leg Ass Debates*, 1925, Vol 5, Pt 1, pp 715 and 719

a material consideration, at least from the official standpoint and while presenting the Budget for 1927-28, the Finance Member, Sir Basil Blackett, estimated the loss to the Government that a reversion to 1*s* 4*d* ratio would cause at Rs 5.26 crores [1]

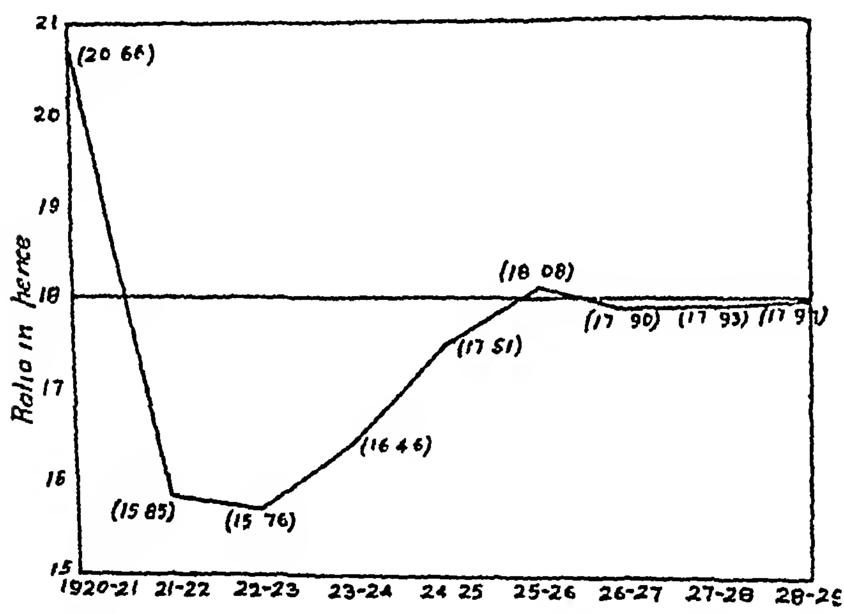
Though the comparative merits of stability of exchange and stability of internal prices were never made a prominent issue in the ratio discussions, it is interesting to find that a choice between the two was implicit in whatever position was taken by the participants Those who began to urge on the government the advisability of stabilising exchange from 1924 onwards—*i e* in an admittedly unstable world—were unconsciously showing a preference for exchange stability. On the other hand, the Government by allowing the exchange to rise and fall—whether by folly, helplesness or design—contributed in an unpremeditated way towards the maintenance of internal price stability The debate on the ratio in 1926-27 would have been conducted perhaps on a higher plane and to better purpose if the necessity of flexibility in exchange and the importance of the internal stability of prices had been brought out as the crucial points

Examining the ratio controversy in retrospect, it seems that the opponents of 1*s* 6*d* had better judgment on their side It is true that there can be no such thing as a "natural" ratio because given a certain amount of deflation or inflation, any ratio can be accomplished for the time being and the internal price level will get adjusted to such a ratio The argument for 1*s* 4*d* that it was the "natural rate" was meaningless Nor should the case for 1*s* 4*d.* have rested on its being the pre-war parity, for the decision to adopt a particular ratio has to be made with reference to the prevailng facts as regards prices, trade conditions, wages, etc The economic conditions prevailing in India from 1927 to 1931 furnish no evidence that 1*s.* 6*d* rate contributed to stability and progress The two years 1927-28 and 1928-29 were no doubt years of

[1] *Leg Ass Debates*, 1927, Vol 2 p 1464 When, however, Mr T Gavin-Jones pertinently asked if the Government had gained an equal amount by a rise in ratio to 1*s* 6*d* the Finance Member gave a flat but unconvincing denial (*Ibid* p 1881)

comparative stability and expansion of trade It is probable, however, that the stability or trade expansion was secured in spite of 1*s* 6*d* ratio It was the Indian counterpart of increasing world stability and expansion of world trade When the downward trend of prices and trade began, 1*s* 6*d* rate, which itself was never firm in the saddle, accentuated their fall in India The Government refused to accept such a view [1]

The following graph based on the average of the daily telegraphic transfer rates from Calcutta on London shows exchange fluctuations from year to year —



[1] Sardar Sant Singh asked in the Legislative Assembly on September 9 1931 for a statement on the loss caused to India by fall in prices due to action of Government of India in maintaining exchange at 1*s* 6*d*

Sir George Schuster replied 'I regret I do not understand the question The fall in prices has been due not to the maintenance of exchange at 1*s* 6*d* but to the general world causes If for example, exchange had been fixed at 1*s* 4*d* in 1927, India would have felt the full shock of the fall in world prices for all her main commodities just as much as she is feeling it now The percentage fall would have been the same "—*Legislative Assembly Debates*, 1931, Vol V, pp 108-09

CHAPTER IX

VIII Period September 1931—August 1939

CRISIS AND AFTER

§ 1 LINKING THE RUPEE TO STERLING

On September 21, 1931, the British Government in consultation with the Governing Body of the Bank of England suspended sub-section *(ii)* of Section I of the Gold Standard Act of 1925 This sub-section laid an obligation on the Bank of England to give gold bars in exchange for internal currency When this obligation was removed, sterling was divorced from gold and England was off the gold standard Sterling, no longer convertible into gold, began to depreciate steadily in relation to it. It is not possible here to go into the causes of abandonment of the gold standard by England Nor is it very necessary to do this to understand the reaction of that event on the Indian currency system

The rupee was linked to sterling by the Currency Act of 1927 at the rate of 1*s.* 6*d.* but so long as sterling was convertible into gold the rupee was virtually on a gold basis Now when sterling had no longer a fixed relation to gold the Government of India had to decide about the basis and the rate of the rupee afresh Five alternative courses were open to them —

(*i*) To link the rupee to sterling at 1*s* 6*d* *i.e*, to maintain the statutory obligation laid on the Government of India to sell sterling in exchange for internal currency at 1*s* 6*d* Re.

(*ii*) To link the rupee to gold at 1*s* 6*d* rate *i e*, to make the rupee convertible into gold at one rupee=8 47512 grains of gold

(*iii*) To link the rupee to gold at a rate lower than 1*s* 6*d*

(*iv*) To link the rupee to sterling at a rate lower than 1*s* 6*d*

(v) To leave the rupee free i e, to link it neither to gold nor to sterling but to allow its exchange value to fluctuate according to its purchasing power relatively to that of other currencies and other market influences This implied, of course, a kind of controlled inflation because left completely to itself, the exchange value of the rupee would fall to its bullion value

Of these, the Government ultimately chose the first course As soon as England went off the gold standard, the Governor General-in-Council issued an Ordinance (No VI of 1931) removing the obligation placed on the Government by the Currency Act of 1927 to sell gold or sterling [1] The position thus created was that the rupee was delinked from both gold and sterling [2] Three bank holidays were declared presumably to prevent a run on the banks by the public in an unreasoning fear

A third event of outstanding importance which occurred on the same day i e, the 21st September 1931, was that the Secretary of State for India made a statement before the Federal Structure Sub-Committee of the Indian Round Table Conference informing them that it had been decided "to maintain the present standard on sterling basis"

On 24th September 1931, therefore, Ordinance VI was repealed and another Ordinance (No VII of 1931)[3] was passed This Ordinance restricted sales of gold or sterling to genuine trade purposes and reasonable personal requirements The rules made under the Ordinance laid down £25,000 as the maximum amount of gold or sterling to be sold to any recognized bank and empowered a Managing Governor of the Imperial Bank to call upon any recognized bank to satisfy him that it was purchasing gold or sterling only for purposes

[1] The purchase of gold at the Mint was, however, not stopped

[2] Mr Arthur Moore asked in the Legislative Assembly on 21st September 1931 if steps would be taken to link the rupee with sterling during the period when it might be temporarily divorced from gold Sir George Schuster replied that they had not had time to settle their detailed plans (*Legislative Assembly Debates*, 1931 Vol V, page 714)

[3] The Gold and Sterling Sales Regulation Ordinance, 1931

permitted under the Ordinance[1] The object underlying al these restrictions was to maintain the sterling value of the rupee at 1*s* 6*d* In the absence of such restrictions, it wa feared, rupee would seek conversion into foreign currencie in large quantities, causing weakness in exchange[2]

The action of the Government in linking the rupee tc sterling was probably the best under the circumstances but it led to a good deal of criticism partly because it was taken without consulting the Indian Legislature or public opinion and also because the old ratio was maintained The ratio question has been discussed in another chapter. As for linking the rupee to sterling, was any other course of action feasible?

The alternatives to a link with sterling were a link with gold and a "free" rupee If the rupee had been linked to gold at 1*s* 6*d* or 1*s* 4*d* rate (*i e*, made equal to 8 47 or 7 53 grains of gold), strong gold reserves would have been necessary to maintain the link But at that time, the gold portion of the Paper Currency Reserve was very low and the gold stock amounted to £32⅓ millions sterling (£ sterling on its previous parity)[3] To maintain the convertibility of the rupee into gold at a time when there was rush for gold in other countries,

[1] This does not mean that sales of gold were provided for by the Ordinance or a link with gold established The position was that the Ordinance modified the Currency Act of 1927 The option of the Currency authority to sell gold or sterling remained but the amount of gold or sterling was restricted to £25,000 When the Ordinance was cancelled on 30th January 1932, the Currency Act of 1927 came into force again

[2] The Government of India have had to take into account the possibility that in present conditions of uncertainty as to the international position there might be an inducement to speculators to take advantage of unlimited facilities offered by the Government to acquire sterling exchange and that might operate to the detriment of genuine traders and of public interest"—*Sir George Schuster s statement in the Legislative Assembly*

In Bombay, in the first ten minutes after business opened and before the markets were aware of the issue of the Ordinance, demands for 4,25,000 pounds sterling were received"—*Sir George Schuster s reply Legislative Assembly debates*, 1931

[3] Sir George Schuster s statement in the Legislative Assembly on 24th September, 1931

deflation might have become necessary Besides, a fixed ratio in terms of gold would have meant a fluctuating ratio in terms of sterling so long as sterling depreciated in relation to gold A fluctuating sterling rate would have reacted adversely on India's trade with Great Britain and other countries which linked their currencies to sterling If 1*s* 6*d* sterling rate was regarded as unduly high for India, 1*s* 6*d* gold rate (which meant much more than 1*s* 6*d* sterling) would have been still more objectionable

A "free" rupee—the other alternative course—implied some kind of controlled inflation It might have meant somewhat unstable exchange but in any case it involved greater currency control with some definite object or objects in view, *e g*, raising or maintaining the internal price level in parity with costs Such control requires initiative, foresight and boldness of action and does not offer the advantage of comparative stability The Government, however, wanted primarily an anchor for the rupee so that in paying off sterling loans and meeting other sterling obligations they might be relieved of the inconveniences and risks of an unstable exchange

The linking of the rupee to sterling tied the rupee to the chariot wheels of depreciating sterling In relation to gold or currencies based on gold, it depreciated along with sterling The depreciation of the rupee raised Indian prices and tended to stimulate exports to countries having currencies based on gold and to discourage imports from them [1] In actual fact, the stimulus to exports was in large part neutralised by declining world prices and high import duties and other restrictions imposed by most of such countries As for imports

[1] An example would make this clear If, before England went off the gold standard, one £ was equal to 4 86 dollars (gold), an American commodity worth 4 86 dollars could be purchased for one £ or Rs 13-5 4 (at 1*s* 6*d* rate) After England went off the gold standard the pound sterling or paper pound was no longer equivalent to 4 86 dollars (gold), it became owing to depreciation equivalent to let us say 4 25 dollars (gold) In other words, to purchase the same American commodity worth 4 86 dollars gold, more than one pound sterling had to be paid and since the rupee was linked to sterling at the old ratio more than Rs 13-5-4 had to be paid And for an Indian commodity selling for 4'86 dollars more than Rs 13 5-4 were received

from these countries, they became dearer in the Indian market and the British goods obtained an advantage in competition—a sort of preference by the back door. The advantage or preference was not enjoyed for long because other countries, too, either went off gold or devalued their currencies one by one It may be added here that this advantage would have accrued to *Great Britain even if the rupee had been linked to* gold.

The stabilization of the rupee in terms of sterling enabled the Government to meet its sterling obligations without embarrassment or uncertainty and led to marked improvement in India's credit.

The most important and probably the most far-reaching effect of linking the rupee to sterling was the export of gold from India in enormous quantities. The Government did not interfere with the export of gold which went on unchecked. An embargo or a high duty on gold exports or the purchase of gold by the Government was vehemently urged by those who considered export of gold injurious to the country.[1] The Government did not take this view and took no action and have taken none so far The issues raised by gold experts are important and have been discussed below (§ 2) Only this may be mentioned here that the gold exports strengthened the exchange rate which consequently showed a tendency to rise above 1*s*. 6*d*. At a time when exports of merchandise had fallen and the balance of trade in merchandise had shrunk greatly, the gold exports created a large balance of trade in favour of India The exchange became firm and during the next 4 or 5 years remained at a premium except for very brief intervals

§ 2. GOLD EXPORTS

After England went off the gold standard on September 21, 1931, and the rupee ratio was fixed in terms of sterling at

[1] The Federation of the Indian Chambers of Commerce and Industry passed on the 26th March 1932, a resolution strongly urging on the Government of India 'the desirability of placing an immediate embargo on the export of gold from India' and the necessity of purchasing gold in the open market'

1*s* 6*d*, the price of gold rose from about Rs. 21 per tola to Rs 25 and in December 1931 stood above Rs 30 At the same time export of gold from India commenced on a large scale and has continued ever since though in progressively decreasing amounts.[1] The quantity and value of gold exported and the average price of gold are given below —

	Net amount of exported gold (millions of fine oz)	Value (crores of rupees)	Average price of gold per tola (in rupees)*
1931-32	7 73	57 98	25-9 0
1932-33	8 35	65 52	30 9-0
1933-34	6 70	57 05	33-4-0
1934-35	5 69	52 54	35-7-0
1935-36	4 02	37 36	35-8-0
1936-37	3 01	27 85	35-10-0
1937-38	1 77	16 33	36-1-0
1938 39	1 35	13 05	37-12-0
1939-40	3 16	34 67	41-14-0

* From Statistical Abstract for British India 1930-31 to 1939-40

The issues raised by gold exports may be discussed under the following headings —

1. The relation between gold exports and the linking of the rupee to sterling at 1*s* 6*d* rate.
2. The relative influence of economic distress and rise in the price of gold in causing gold exports
3. The possible effect on gold exports of the adoption of an alternative course, say, linking the rupee to gold
4. The economic implications of gold exports and of the measures that might have been taken to check them.

Owing to the economic distress caused by the heavy fall in agricultural prices during 1930-31 and possibly intensified by 1*s* 6*d* ratio, gold had begun to be sold by the people in rural areas much before England went off the gold standard Mr (now Sir) M L Darling, the Registrar of Co-operative Societies, Punjab, who undertook a tour of the Punjab villages in the cold weather of 1930-31 found gold being sold to meet Government dues. "The following summer", he says, "the market price of wheat having fallen to Re 1-6-0 a maund, sale in canal irrigated tracts became very brisk . Even when the price of gold rose 50 per cent, nearly all the gold that

[1] It increased somewhat in 1939-40

came upon the market from the village—and most of it came from this source—was distress gold, and those who were not obliged to sell, for instance, the larger land-owners, did not do so. In the town, too, it is only the very modern minded who are prepared to part with their ornaments for any other reason but necessity."[1]

Another enquiry undertaken by the Punjab Board of Economic Enquiry in £20 Punjab villages also showed that the sales of gold were due to stern pressure of economic necessity.[2] No such information about other Provinces is available but it appears that upto September 1931 at least, gold was sold mostly out of necessity A large part of it went ultimately into the hands of bullion dealers in the cities but a good deal was acquired by the Government also [3]

Two questions at once arise. why did the price of gold rise ? Why was gold exported ? The price of gold in terms of rupees rose because sterling was depreciating in relation to gold and as the rupee was chained to sterling, it, too, depreciated. In other words as more sterling had to be given to get the same amount of gold, more rupees had also to be given [4] The depreciation of sterling in relation to gold could be measured by its depreciation in relation to a currency still based on gold *i e*, dollar or franc The rupee price of gold, therefore, varied with fluctuations in sterling-dollar rate and later, in sterling-

[1] M L Darling *Wisdom and Waste in the Punjab Village*, pp 320-21

[2] *Note on the sales of gold and ornaments in the Punjab villages Chapter IV*—"There is a mass of evidence coming from all parts of the Province to bear out the conclusion that necessity and economic pressure were the predominant forces behind the larger part of the sale of gold" P 10

[3] " Although we have lost a certain amount of our Currency Reserve in the last two months, we have not lost a single penny of our gold reserves and our actual gold reserves stand at about £7 millions sterling higher than they did an year ago, owing to the receipts of gold from up-country "—*Sir George Schuster (Legislative Assembly debates, September, 1931)*

[4] A small example would make this clear Suppose, on 19th September, one pound sterling was equal to 113 grains of gold On 25th September, owing to depreciation of sterling, 1¼ pound sterling let us say, became equal to 113 grains of gold If the sterling ratio of the rupee remains the same, *i e*, *1s 6d*, Rs 13-5-4 will purchase 113 grains of gold on the first date and Rs 16-10-8 the same amount of gold on the second

franc rate

It may be pointed out that even if the rupee had not been linked to sterling but left free, the price of gold in terms of rupees would have risen. The rupee would have depreciated in relation to gold and the rupee price of gold risen Only if the Government had linked the rupee to gold at a definite rate, such a rise could have been avoided

A rise in the rupee price of gold naturally created a strong inducement for the people to sell gold Those who were forced by economic necessity parted with it more freely and others who wanted to take advantage of its high price began to convert their gold hoards into productive investments such as deposits in banks, purchase of land etc In both the cases the rise in the rupee price of gold brought gold out of the hoards in big amounts How much of this gold was "distress gold" and how much "investment gold" must, however, remain very much a matter of conjecture.

The *export* of gold as distinct from its *sale* within the country was however, due not to a rise in its price but to the difference between the sterling price and rupee price of gold The sterling price being higher, the bullion dealers found it profitable to export gold. The fixed ratio of 1*s* 6*d* sterlinghelped this outflow of gold by keeping up this margin of profit while a rising exchange ratio would have extinguished it by bringing the bullion dealers less rupees in return for the sterling obtained for gold sold

The exchange left to itself might have risen in response to the stimulus of gold exports It may be recalled that a free rupee was suggested as one of the alternatives to fixed sterling rate A "free" exchange would have been a rising exchange and though it would have checked gold exports, it might have completely disorganised trade The only other alternative was to have linked the rupee to gold at a low rate, thus to have raised the rupee price of gold higher than its sterling price and made the export of gold unprofitable The Government could then have purchased gold in the market at that price and sold part of it to pay off its sterling debts and to meet other obligations

The whole position must, therefore, be examined with

reference to the economic benefit or loss to the country caused by gold exports. If gold exports were beneficial on the whole, no criticism of the sterling link or ratio need be made on that account. If gold exports were injurious to the interests of the country, the measures that could be taken to check them, including a change in the basis or exchange value of the rupee, deserve consideration.

The case in favour of gold exports being left unchecked was ably put forward by Sir George Schuster, the Finance Member and other official spokesmen.[1] Gold was sold, they said, to tide over a period of exceptional difficulty and the Government were not justified in interfering with people's right to sell gold and reap the benefit of a high price. If gold hoards were not to be drawn upon by the people in hard times, what purpose did they serve? Besides it was far better that gold was taken out of hoards and relieved economic distress or got converted into profitable investment than that it should have continued to lie barren and unproductive Gold exports also enabled the country to maintain a favourable balance of accounts and their quantity was small compared to the vast reservoir of gold built up in years preceding 1931.

Gold exports enabled the Government to obtain large quantities of sterling and to pay off the sterling debt of £15 millions which matured on 1st January, 1932. They also made it easy for the Government to meet recurring sterling obligations and to reduce the floating debt in India. The credit of the Government, therefore, greatly improved and the rates at which the Government could borrow were substantially lowered. To cancel the sterling obligations by selling gold at a time when sterling price of gold was high was definitely a wise measure.

The position of the reserves was strengthened by the addition to them of sterling securities. During the 15 months from September 1931 to December 1932 gold of the value of £80 millions was sold. External balances of currency of

[1] Budget Speech, 1932, paras 69-75, 1933, paras 17-27—*Legislative Assembly Debates, 1932, Vol II and 1933, Vol II*

The address by His Excellency the Viceroy to the Legislative Assembly, 1932—*Legislative Assembly Debates, 1932, Vol I*

£80 millions were thus acquired of which the Government acquired £69½ millions by open purchases in the market as currency authority Out of this they used £34 millions for meeting current requirements and £35½ millions to reduce India's external obligations and strengthen the reserves

These arguments in favour of gold exports could be reinforced further by others which supported the official point of view The export of gold strengthened the rupee sterling exchange in particular and sterling in general. It stimulated Indian exports by raising the purchasing power of countries importing gold and also encouraged imports into India by enabling sellers of gold to purchase imported commodities The sellers of gold made an enormous gain because they purchased it when it had a lower value in goods and rupees and sold it when it had appreciated in terms of both goods and services[1] Above all, sterling had had a more or less steady value in terms of goods, was a more secure international currency than gold and while the future price of gold was uncertain, sterling was appreciating in terms of other currencies[1] It was highly improbable that gold would have the same position in the world's monetary systems (even if they went back on gold) as it had before and for India at least an independent standard—not a gold standard but a standard backed by moderate quantity of gold and aiming at internal stability—would be most desirable It was better, therefore, to have sold out gold and invested part of it in interest bearing securities than to have retained it in the country as a dead asset

Indian commercial and public opinion was, however, opposed to unrestricted outflow of gold. An embargo on gold exports and the purchase of gold in the open market by the Government were urged by the Federation of the Indian Chambers of Commerce and Industry[2] The main grounds

[1] B P Adarkar 'A Review of Gold Export Fallacies' in the *Indian Journal of Economics*, January, 1936 Paras 10 12 and 21 Also A D Gayer 'The paper moneys of the Sterling area retained a remarkable steady purchasing power on the whole while gold underwent an outrageous appreciation in value" —*Monetary theory and economic stabilisation*, p 175

[2] Resolution of the Federation of Indian Chambers of Commerce, dated 26th March, 1932.

on which the Government policy of non-interference with gold exports was criticised were five, *firstly*, the Government had been parting with an appreciating commodity, gold, for a depreciating commodity *i e.*, sterling and the loss thus incurred was far in excess of any interest that might be earned on sterling securities, *secondly*, it was doubtful if "the dethronement of King Gold from his proud position" had really been accomplished and so long as it was not accomplished there was an obvious advantage in retaining within the country a metal which the world might in future once again adopt as the basis of credit, *thirdly*, if the Government had bought the gold and after selling a part of it to meet its sterling obligations retained the rest, they could have used it *later to strengthen the banking reserves of the country*, *fourthly*, if the price of gold rose in future due either to increased world demand for gold or decline in its production, the gold that was exported would have to be purchased, if it was required, only at a loss *Fifthly*, gold exports had thrown a veil over the seriously shrinking balance of trade and prevented a clear appreciation of the alarming deterioration in the country's position as an agricultural producer and as a debtor on international account

The role of gold in the future monetary systems of the world was an important consideration in the discussion about gold exports. If gold was going to occupy the same position as before 1931 and the countries were to return to some form of gold standard, the Government policy of non-interference with gold exports justly deserved criticism. It could be maintained, however, that even in the event of other countries returning to gold after building up their gold reserves, India might find it advisable to have an independently managed monetary system not based on gold This would bring the discussion back to the old question would any currency standard without a tangible gold backing inspire public confidence and would not, in the absence of such confidence, the uneconomic habit of hoarding continue? If the end in view was an independent monetary system managed with a view to internal stability, only a drastic remedy like a liquidation of the entire stock of gold at an early date to

be followed by prohibitive duties on both gold and silver[1] could meet the demands of the situation. This negative remedy might have been supplemented by a positive one *i e*, the establishment of a network of some kind of savings banks adapted to the needs of rural people all over the country

Leaving aside for the present the question of the monetary standard of the future,[2] it might be asked if there was a way by which the Government could retain gold within the country If the rupee had not been linked to sterling, an embargo could be placed on gold exports and gold purchased by the Government The Government could then have stabilized the rupee in terms of gold and sold the gold thus acquired to purchase sterling, which was progressively depreciating, to cancel sterling debts. The inflation caused by gold sales could have been neutralised to the required extent by raising loans in the market A planned 'reflation' could thus have been undertaken

After the rupee had been linked to sterling, an interference with gold exports was unnecessary The Government acquired sterling to pay off sterling debts and strengthened the reserves by purchasing sterling securities Inasmuch as the rupee was linked to sterling, a definite advantage was obtained by cancelling sterling debts and adding sterling securities to the reserves One benefit of gold exports *i e*, a rise in prices due to issue of fresh currency was, however, not obtained owing to the replacement of a part of gold in hoards by rupees and currency notes and the depressing effect of the rapid decline in world prices

While an embargo on gold or Government purchase of gold had very little to recommend it after the rupee had been linked to sterling, the same could not be said of a small export duty on gold If the duty had fallen ultimately on the bullion dealers, it was amply justified and even if it had come out of the unexpectedly high price obtained by the seller of gold, it would have been unobjectionable. The pro-

[1] See *Indian Journal of Economics*, January 1936
[2] See Chapter XI, §3

ceeds of such a duty could be utilised to relieve the economic distress in rural areas.

§ 3. Government's Sales of Silver

The export of silver from India was also stimulated by the abandonment of gold standard in September 1931[1] This was, however, small compared to the large quantities sold by the Government of India from 1927 onwards. The silver sales were undertaken in accordance with the recommendations of the Hilton Young Commission. The Commission held that when convertibility of notes into rupees was abolished under the system proposed by them and one rupee notes were introduced, big reserves of silver would be unnecessary. They, therefore, recommended that the unduly large stocks of silver in the Paper Currency Reserve should be gradually reduced from about Rs 85 crores to Rs. 25 crores in about ten years. They also recommended that 'no favourable opportunity of fortifying the gold holding in the Reserve should be allowed to escape'[2]

When the Commission reported there were 91 crores of rupees in the Reserve The Government of India began to sell silver in 1927 and upto 31st March 1934 had sold a little over 196 million fine ounces of silver or about 57 crores of rupees They still held 104 crores of rupees in September, 1933, *i e*, there was an increase in stocks owing to the return of silver coins to the Reserve, for people had begun to substitute gold for depreciating silver in their hoards A loss of about 33 crores was incurred by the Government on the sales The proceeds of silver sales were utilized not to increase gold reserves but to meet current requirements[3] The silver sales depressed the price of silver and also resulted in deflation of currency.

By the International Silver Agreement of July 1933, the

[1] Report of the Controller of Currency, 1931-32, para 25

[2] Report of the Hilton Young Commission, paras 78 and 80

[3] "Out of the silver we have sold we have realized about £15¾ millions which has helped us to avoid borrowing " S. *George Schuster's speech on 21st November, 1933*

Government of India bound themselves to sell not more than an average of 35 million ounces (equivalent to 9 crores of rupees) annually for four years i e., from 1st January, 1934 to 31st December, 1937. This coupled with the agreement of U S A and other silver producing countries not to sell silver but to purchase 35 million ounces annually stabilized the price of silver During 1938-39 the price remained fairly steady varying between Rs 48 and Rs 53 per 100 tolas The purchasing policy of the United States Government was during this period the main prop of the silver market.

§ 4. THE RESERVE BANK OF INDIA

The determination of the Government to maintain the sterling link of the rupee at 1*s*. 6*d* was made clear beyond doubt in 1934 when the Reserve Bank of India Act was passed The question of monetary standard best suited to India was left to be considered when the international monetary position became clear and stable and the Reserve Bank of India was placed under a legal obligation to maintain rupee-sterling ratio at 1*s*. 6*d*

The establishment of the Reserve Bank of India in 1935 ended duality in the control of currency and credit It gave promise of a new era of systematised currency and credit-control exercised to secure monetary stability The constitution of the Bank bears most of the features incorporated in the Bill of 1927 which was dropped finally in 1928 The Bank is a shareholders' bank with an original capital of Rs 5 crores divided into shares of Rs 100 each. The risk of political influence entering the bank has been sought to be eliminated by making it a private shareholders' bank To check the tendency towards the concentration of shares in a smaller number of hands, a provision was made in 1940 that no shareholder of the Bank can come in possession after the 26th March 1940 of additional shares of the value of more than twenty thousand rupees The supervision and the direction of the Bank's affairs have been entrusted to a Central Board of Directors composed of sixteen members—one Governor and two Deputy Governors, twelve Directors and

one Government official Of these the Governor and two Deputy Governors, four Directors and the Government official (i e., eight members in all) are to be appointed by the Governor General-in-Council, the remaining being elected, but a Deputy Governor and the Government official are not entitled to vote There are five Local Boards of the Bank, in Delhi, Madras, Bombay, Calcutta and Rangoon. Salaried officials of the Government or Indian States, insolvents, people of unsound mind, bank employees and directors of banks other than co-operative banks cannot become Directors or members of a Local Board of the Bank but the Governor, Deputy Governor and the Government official on the Central Board are eligible even if they are salaried officials, bank directors or bank employees

The Reserve Bank of India has been assigned the role and the functions of a central bank and transacts such business as it has been authorized to transact by the Reserve Bank of India Act, 1934. It has the sole right to issue bank notes which have replaced gradually the Government of India currency notes.[1] The Reserve Bank notes are legal tender and are guaranteed by the Governor General-in-Council Bank notes of the denominations of Rs. 5 and Rs 10 were issued in January and February 1938 and those of Rs. 100, 1000, and 10000 later during the same year Notes of the denomination of Rs 2 were issued in 1943 to meet the special requirements of war conditions

The Bank has to receive money and make payments on behalf of the Secretary of State and Central and Provincial Governments It receives the cash balances of Central and Provincial Governments and carries out remittance, exchange and banking business on their behalf. It has been entrusted with the management of public debt and the issue of new loans It can accept money on deposit without interest from, and collect money for, the Secretary of State, Central and Provincial Governments, local authorities, banks, and other persons. It can also make short term advances for periods,

[1] As the Bank was (and continued to be even after the separation of Burma in 1937) the central bank for Burma, it issued notes of distinctive design for Burma

generally not exceeding three months, to Central Government, Provincial Governments, Indian States, local authorities, scheduled banks and Provincial Co-operative Banks It can act as agent for the Secretary of State, Central and Provincial Governments, States and local authorities for purchasing and selling gold and silver, bills of exchange, shares and securities and for collecting interest and dividends.

Besides these various kinds of business transacted for the Government, the Bank can purchase, sell and rediscount bills of exchange and promissory notes drawn on and payable in India or England It can purchase and sell specified securities, gold coin and bullion It can borrow money for a period not exceeding one month and enter into agency agreements with an international bank or central banks of other countries

The Bank has been empowered to undertake open market operations, that is, on special occasions it can discount bills of exchange and make loans and advances directly and thereby expand, contract or stabilize credit Normally the Bank will deal with scheduled banks and Provincial Co-operative banks and only on special occasions will it have to come into the open market *i e*, deal directly with the public at large. Open market operations furnish a powerful instrument by which a Central Bank can regulate credit on emergent occasions

The bank is under an obligation to maintain rupee sterling rate at 1*s* 6*d* by buying sterling at a rate not higher than 1*s*. $6\frac{3}{16}d$ for a rupee and selling sterling for immediate delivery in London at a rate not lower than 1*s* $5\frac{49}{64}d$ for a rupee The amount of the sterling bought or sold is to be not less than £10,000

The bank has an Issue and a Banking Department. The liabilites of the Issue Department arise from the note issue and the assets of the Department consist of gold coin, gold bullion, sterling securities, rupee coin, rupee securities and bills of exchange and promissory notes payable in British India Of the total amount of assets not less than 40 per cent is to consist of gold coin, gold bullion or sterling securities and the amount of gold coin and bullion is to be not less than Rs. 40

crores in value.[1] Of the total gold coin and bullion not less than 85 per cent is to be held in British India[2] The Bank has taken over the whole of the gold coin and bullion in the Gold Standard Reserve and the Paper Currency Reserve and has assumed the liability of the currency notes of the Government of India The liabilities and assets of the Issue Department on 15th October 1943 are shown below—

Liabilities	Rs	a	p	*Assets*	Rs	a	p
Notes held in the Banking Department	14,28,43,000	0	0	A Gold coin and bullion—			
				(*a*) Held in India	44,41,43,000	0	0
Notes in circulation	7,76,52,40,000	0	0	(*b*) Held outside India			
				Sterling securities	6,74,75,01,000	0	0
				Total of A	7,19,16,44 000	0	0
				B Rupee coin	13,22,91,000	0	0
				Government of India rupee securities .	58,41,48,000	0	0
				Internal bills of exchange and other commercial paper			
Total notes issued	7,90,80,83,000	0	0				
Total liabilities	7,90,80,83,000	0	0	Total Assets	7,90,80,83,000	0	0

Ratio of total of A to Liabilities 90-94 per cent

[1] The most notable change in the composition of the assets brought about by the war is the enormous increase in sterling securities (from Rs 59 5 crores on the last Friday of August 1939 to Rs 674 7 crores on 15th October 1943)

[2] The whole of gold bullion and coin is now held in India and is valued at the old rate of 8 47512 grains of gold per rupee or Rs 21-3-10 per tola, giving at the present value of gold (October 1943), a hidden reserve of over Rs 100 crores

The Reserve Bank of India is a bankers' bank and Scheduled Banks which numbered 67 on 30th June, 1943, have to maintain with it a balance amounting to at least 5 per cent of their demand liabilities and 2 per cent of their time liabilities Demand liabilities generally mean deposits withdrawable on demand and time liabilities deposits repayable after some period The maintenance of a balance by the Scheduled Banks with the Reserve Bank is necessary because to make its policy effective, the Bank must have adequate resources and must be able to influence the credit policy of member banks In actual fact, however, the banks have had ample resources of their own to lend and have rarely sought accommodation from the Bank The bank rate has remained unchanged at 3 per cent since 28th November, 1935

The greatest difficulty in controlling the monetary system in India arises from the existence of a vast mass of indigenous bankers and money-lenders who are responsible for about 90 per cent of the credit transactions These bankers must be linked up with the Reserve Bank In August 1937, the Bank formulated a Draft Scheme for the direct linking of private bankers but as the conditions laid down in the scheme, such as closing other than banking business within a certain period and proper maintenance and audit of accounts did not suit the indigenous bankers, nothing came out of it Meanwhile the Bank has collected and published[1] information about the operations of the non-scheduled banks with capital and reserves of rupees 50,000 and over and tried to develop contacts with them A more conclusive manner in which the Bank is trying to secure proper regulation and control of the banking system is by urging the need of enacting comprehensive banking legislation.[2] The necessity and importance

[1] *Memorandum on Non-scheduled Banks* 1939

[2] Proposals for an Indian Bank Act were first made by the Bank in 1939 but in July 1941 the Government of India informed the Bank of its decision not to undertake comprehensive banking legislation in the existing abnormal war conditions On 30th December 1942 again the Bank made two suggestions to the Government for the regulation of banking firstly, that provision should be made in the Companies Act that subscribed capital must not be less than half the authorized capital and the paid up capital not less than half of the subscribed capital and

of such legislation have been enhanced by the spate of bank floatations during the war and by the apprehended danger of widespread banking collapses in the post-war period

The Bank has also created, in compliance with its statutory obligation, a special Agricultural Credit Department to link its machinery with rural credit agencies and to maintain an expert staff to study all questions of rural credit and give advice to governments and banks. A preliminary report of the Department on the main features of the rural credit problem was published in December 1936. A full report was submitted to the Government in 1937 indicating the various directions in which improvements might be made to enable the rural credit agencies to render better service to the agriculturist and the manner in which the Reserve Bank could render assistance In a series of circular letters issued since 1938, the Bank has defined the conditions under which it would be prepared to provide finance to co-operative banks. Meanwhile the Department is engaged in an intensive study of problems relating to rural finance and in tendering advice to provincial agencies purveying rural credit

The outbreak of the war in September 1939 led to the establishment of a new Department of the Bank—the Exchange Control Department—to administer the various regulations relating to dealings in foreign exchange The Department keeps in close touch with the Empire Exchange Control on the one hand and with the banking institutions and dealers authrorised to deal in foreign exchange on the other.

The Bank has to pay a part of its profits to the Government after meeting its expenses and paying a dividend, fixed at 3½ per cent upto 1942 and fixed by an Ordinance at 4 per cent since 1943 to the shareholders The net profits and the amounts paid to the Government have been as follows .—

secondly, that no banking company should have other than ordinary shares The Government of India invited opinions on the Bank's suggestions in March 1943

In lacs of rupees approximately

Year	Net profits	Amount paid to the Government
1935 (nine months)	56 06	42 9
1936	53 42	35·9
1937	27·91	10 4
1938	38 45	20·9
1939	22 50	5·0
1940 (six months)	29 29	20 5
1940-41 (June—May)	279 26	261·7
1941-42 (June—May)	341 54	324 0
1942-43 (June—May)	769·81	749·81

The Bank keeps up a continuous exchange of information with the foreign central banks and watches closely the economic and financial trends in other countries Through its Research Section which was placed under the charge of a Director of Research in May 1940 it collects data and organises research into subjects which are its direct concern It also issues, besides its Annual Report on Currency and Finance, a number of other periodical and topical publications

In maintaining stability of exchange and regulating credit, the Reserve Bank of India has acted in close collaboration with the Government of India Mutual consultation and advice between the central banking institution of a country and the Government are part of a well established procedure all over the world and as the ultimate end of the two authorities is the same, chances of difference of opinion between the two are reduced to the minimum In India, however, it is possible that the expectations of the public from the Reserve Bank whom they are learning to look upon as the supreme national banking institution may not always square with the predilections of the Government in certain important matters of policy The resignation of Sir Osborne Smith, the first Governor of the Bank, in 1936 owing to differences (as the rumour had it) with the Finance Member of the Government of India and the appointment of the late Sir J B Taylor, a member of the Indian Civil Service, as Governor did not seem to augur well for the growth of sound traditions of central banking. But now on an appraisal of eight years'

record of the Bank's working it may be said that it has endeavoured to serve India well and has in spite of several difficulties and obstacles laid firm and secure foundations for its future progress. The scope and value of its activities have steadily grown and it may safely be asserted that in the absence of the Reserve Bank, the handling of the monetary problems created by the war in India would have been a far more difficult affair The appointment of Mr C. D. Deshmukh as the first Indian Governor of the Bank in August, 1943 is both a pleasing and a significant event in the Bank's career. For the Bank is being called upon to offer its counsels to the Government not only with regard to developments during the war but also in respect of the important plans now under discussion for the world's monetary future and the presence of an Indian of outstanding ability at the head inspires confidence that India's interests will be properly looked after.

§5. PRICES, TRADE, EXCHANGE AND FINANCE (1931-39)

The fall in prices which commenced towards the end of 1929 was particularly heavy in the case of agricultural commodities. As India produces and exports largely foodstuffs and raw materials, the depression made a deeper mark on its economic life than on that of industrially advanced countries The prices of both Indian exports and imports fell from 1929 onwards but the fall was much heavier in those of exports[1] As the exports consist mostly of agricultural commodities and imports mostly of manufactured goods, the real terms of trade turned against India In other words, the unequal fall in the prices of agricultural and non-agricultural goods left India worse off inasmuch as a larger quantity of exports was needed to get the same quantity of imports in exchange

After 1929 there was for some years a continuous decline in the general level of prices as shown by the index numbers of wholesale prices. Both the Calcutta Index Number based on prices of 45 different commodities and the Bombay Index

[1]From September 1929 to June 1932, the prices of exported articles fell by about 47 per cent and of imported articles by only about 16 per cent

Number based on prices of 30 different commodities registered a decline as shown below—

Index Numbers of wholesale prices 1929=100

Year	Calcutta	Bombay
1930	82	87
1931	68	75
1932	65	75
1933	62	68
1934	63	66
1935	65	68
1936	65	66
1937	72	73
1938	68	70
1939	76	75
January 1939	68	69
February ,,	70	68
March ,,	69	68
April ,,	71	69
May ,,	72	70
June ,,	72	70
July ,,	71	69
August ,,	71	71

The bottom of prices was reached in 1932-33 when the fall was a little less than 40 per cent compared to the level in 1929. There was some recovery in the next two years but it was in the latter part of 1936 that prices began to rise and the rise was almost continuous till August 1937. After that the prices began to fall and were generally on the decline till the end of June 1938 when they showed an insignificant rise which was more or less maintained till the end of 1938

The agriculturists who form the bulk of Indian population were in acute distress on account of the heavy fall in prices up to 1932-33 " When the upward movement started in 1932-33 the rise in the prices of commodities in which he (i e, the Indian agriculturist) was interested was painfully slow and halting "[1] With the exception of a short period ex-

[1] *Review of the Trade of India*, 1937-38, p 12

tending from the middle of 1936 to about the middle of 1937, there was during this period extending upto September 1939 no definite upward movement in the prices of primary commodities. Besides an almost constant low level of prices, trade restrictions and currency depreciation resorted to by most of the countries led to a shrinkage of Indian exports and deepened the misery of the Indian agriculturist. The misery was relieved only to a limited extent by the trade agreements entered into by the Government of India with Great Britain in 1932 and 1935 and with Japan in 1934

The value of both exports and imports having fallen heavily after 1931, the balance of trade in merchandise in favour of India shrank rapidly. The actual position in respect of the total balance of trade was, however, masked by the heavy exports of gold which supplemented exports of merchandise The table given below shows the position in respect of exports and imports since 1931.

In crores of rupees

Year	Value of exports of merchandise including re-exports	Value of imports of merchandise	Total visible balance of trade in merchandise	Net exports or imports of treasure	Total visible balance trade of
1931—32	160 55	125 72	+34 83	+55 65	+90'48
1932—33	135 49	132 27	+ 3 22	+64 93	+68 15
1933—34	149 73	114 99	+34 74	+57 23	+91'97
1934—35	155 22	131 80	+23 42	+52 54	+75 96
1935—36	164 29	133 69	+30 60	+36 37	+66'97
1936—37	202 33	124 58	+77 75	+14 50	+92'25
1937—38	202 63	159 18	+43 45	+15 11	+58 66
1938—39	180 29	137 22	+43 07	+22 79	+65 82
1939—40 April—August only)	80 99	60 86	+20 13	+ 5 84	+25 61

Figures for Kathiawar and Travancore ports have been excluded Figures for Burma have been included

It may be noticed that while the total visible balance of trade in favour of India was fairly large throughout, the balance of trade in merchandise fell as low as Rs. 3 crores in

1932-33, increased thereafter reaching a figure of about Rs 78 crores in 1936-37 and fell again in 1937-38 and 1938-39 For India excluding Burma, the balance of trade in merchandise and the total visible balance of trade were as follows —

In crores of rupees

Year	Balance of trade in merchandise	Total visible balance of trade
1935—36 . .	+ 5·1	+40 5
1936—37	+51·2	+64 9
1937—38 .	+15 9	+30 2
1938—39	+17 4	+29·3
1939—40 (April—August)	+ 7 0	+12 2

If gold exports had not taken place on a large scale, the total visible balance of trade in favour of India would have been very small and both the payment of foreign obligations and the maintenance of exchange would have been exceedingly difficult Gold exports thus saved a very bad situation. They steadily fell off, however, and the decrease in them was more than made up by an increase in exports The growth of exports was almost continuous after 1933-34 but the course of imports was somewhat erratic During 1937-38 exports remained more or less steady but imports recorded a rise of about Rs 35 crores In the second half of 1937-38, there was an excess of imports over exports in each month except October and February One reason given for it was that " a lag of this kind is to be expected in a country such as India which exports mainly raw materials and imports mainly manufactured goods Her exports are affected comparatively quickly by world prices and conditions but imports arranged during a time of prosperity continue to arrive after the upward trend has been reversed "[1] The large imports during the latter half of 1937-38 were thus a " carry over " from a period of brisk trade preceding it It did not appear, therefore, that the increase in imports represented a permanent tendency. Dur-

[1] *Reserve Bank Report on Currency and Finance*, 1937-38, p 3 Also *Review of the Trade of India*, 1937-38, p 69

ing 1938-39, both exports and imports registered a decline compared to 1937-38, the balance of trade being +Rs. 66 crores against +Rs 59 crores for 1937-38.[1]

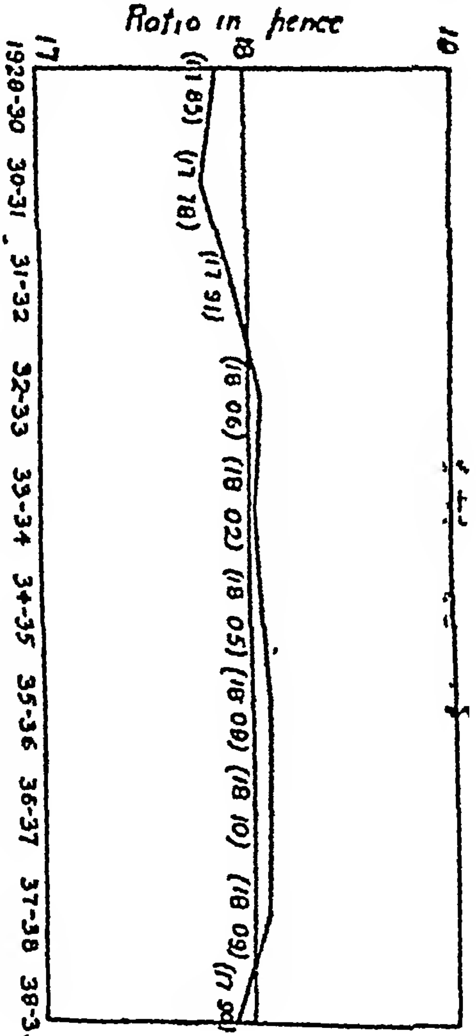
From September 1931 to 1935-36, gold exports kept the total balance of transactions largely in favour of India and the rate of exchange remained firm. Left to itself it might have even risen higher than 1*s*. 6*d*. During the next 3 years (*i.e.*, from 1935-36 to 1937-38) also, the exchange remained firm but the firmness was due to a marked improvement in India's balance of trade in merchandise. Throughout the year 1937-38 as during the previous two years, the rate remained near the upper limit fluctuating between 1*s* $6\frac{1}{8}d$ and 1*s* $6\frac{8}{32}d$[2] From April 1938, however, the effect of falling exports and increasing imports began to be visible on the exchange rate which began to fall and reached a point lower than 1*s*. 6*d* in the first week of June 1938. On June 6, 1938, the Government of India issued a *communique* making it clear that " they are satisfied that the maintenance of the present value of the rupee is required in the interests of India and that the resources available for this purpose are more than ample" and pointing out that " the gold and sterling assets actually in the hands of the Reserve Bank and the Government of India are at the present time worth more than Rs 160 crores " The Government announcement steadied exchange slightly but till the end of 1938, the rate did not rise higher than 1*s* $5\frac{15}{16}d$ In the month of December forward exchange rates weakened and the Government issued another *communique* attributing exchange weakness to movements of funds to United Kingdom by speculators who wanted to bring them back at a profit when the ratio was lowered. They repeated their decision to maintain the exchange at the existing *statutory rate* During the last quarter of 1938-39, there was an improvement in the balance of trade and the exchange rate improved to 1*s*. $5\frac{31}{32}d$ in March 1939. The graph, given on the next page is based on the average of daily telegraphic transfer rates from

[1] There was a comparatively greater fall in the values of goods imported after the beginning of 1938-39 which was attributable partly to the reduction in the volume of imports and partly to the fall in prices

[2] *Reserve Bank Report on Currency and Finance*, 1937-38, p 7

Calcutta on London and shows exchange fluctuations from 1930-31 to 1938-39.

The demand for a lower exchange value of the rupee was pressed on the Government throughout the seven years preceding the war of 1939 by important sections of commercial opinion. One after another England, Scandinavian countries, Egypt, Japan, United States, Belgium, France, Holland, Switzerland, Italy and Czecho-Slovakia depreciated or devalued their



currencies and each addition to the list of devalued currencies created an alarm in India and renewed agitation in favour of a lower exchange rate The large influx of Japanese imports during 1932 due to depreciation of Japanese yen had to be counteracted by the Government by raising high the import duties on cotton piece goods of other than British manufacture In 1933, some prominent businessmen and industrialists formed the Currency League of India "to educate and organize public opinion with a view to opposing the continuation of 18*d.* sterling ratio as is sought to be done through the Reserve Bank Bill and to bring about an immediate devaluation of the rupee" An amendment to the Reserve Bank of India Bill was moved in the Legislative Assembly to secure lower sterling exchange rate but was defeated In October 1936 after the devaluation of franc and other currencies of the gold bloc, the Indian commercial interests grew apprehensive that India's export trade with these countries would receive further set-back while imports from them into India would be stimulated[1] The failure of the Government of India to revise Indian currency and exchange policy in view of the devaluation of these currencies was discussed in the Indian Legislative Assembly on October 8, 1936 In May 1938, the Prime Ministers of the Congress-governed Provinces resolved to secure the co-operation of all the Provinces to send representations to the Government of India for devaluation of the rupee This was a significant move showing that most of the Provincial Governments had come to regard 1*s* 6*d.* ratio as injurious to Indian interests The matter was taken up by the Indian National Congress which passed a comprehensive resolution on the subject on December 14, 1938. The policy of the Government was all along clearly stated, it could be summed up in the words of the then Finance Member, Sir James Grigg: "I will be no party to any monkeying about the present ratio."[2]

[1] It was feared among other things that a devaluation of the guilder might reduce the protective value of the sugar tariff and facilitate imports from Java and that of dollar might encourage the import of American cotton into India

[2] Sir James Grigg's reply to the address of Indian Merchants Chamber (August 1935)

The fall in prices and the shrinkage of trade along with internal political disturbances led to a fall in both Central and Provincial revenues during 1931-32 and 1932-33 To make up the deficiency in central revenue, both retrenchment and fresh taxation were provided for in the Supplementary Finance Act of September 1931 Most of the Provincial budgets also showed deficits and the Provinces which did not receive a square deal under the Meston Award felt the pinch most Economy, retrenchment and taxation were all used to restore budgetary equilibrium but the sagging agricultural prices did not permit any substantial improvement in finances After 1933-34, there was a definite improvement in the central finance but most of the Provincial Governments continued to experience difficulties in balancing their budgets After 1937 these difficulties became particularly acute in provinces under Congress Governments which were losing excise revenue owing to the gradual introduction of prohibition and were undertaking reforms involving increasing expenditure Sir Otto Niemeyer's recommendations embodied in an Order-in-Council[1] provided for financial assistance to all the Provinces by cancellation and consolidation of debts, assignment of a share of the proceeds of Jute export duty (to jute growing provinces), grants-in-aid to some provinces and the distribution of fifty per cent of the yield of income tax among all the Provinces The additional funds thus made available were readily absorbed in either filling up the gap in revenue or meeting fresh expenditure In 1937-38 and 1938-39 sums of Rs 125 and Rs 150 lakhs out of the proceeds of income-tax were distributed among the provinces and a much larger sum of Rs 279 lakhs accrued as the provincial share in 1939-40. Sums of Rs 265 lakhs, Rs 251 lakhs and Rs 256 lakhs were distributed in 1937-38, 1938-39 and 1939-40 respectively as the provincial share in the proceeds of jute export duty Subventions amounting to Rs 312 lakhs, Rs 303 lakhs and Rs. 303 lakhs respectively were also paid to the provinces in the three years The provinces therefore received extra resources amounting altogether to over Rs 22 crores in three years

[1] The Government of India (Distribution of Revenues) Order 1936

(from 1937-38 to 1939-40). Yet the Provinces wanted more funds and it was clear that no lasting benefit could be obtained by them without a substantial rise in agricultural prices and recovery in trade.

§ 6. The Ratio Controversy

Controversy about the correct rate of the rupee in terms of British currency is at least as old as the Fowler Committee of 1898.[1] The Committee had to decide between 1*s*. 4*d*. and a lower ratio and though the majority recommended 1*s*. 4*d*. ratio, a minority argued in favour of a lower rate. The controversy arose again when the majority of the Babington Smith Committee of 1919 recommended 2*s*. (gold) rate and Mr. Dalal wrote a strong minute of dissent. It became acute after the publication of the Hilton Young Commission's report in 1926 and centred round 1*s* 6*d*. rate recommended by the Commission and given effect to by the Government. It may be noted that 1*s*. 6*d* ratio of 1927-31 was virtually a gold rate and 1*s* 6*d* ratio of post-1931 period was a sterling rate—a material difference, seeing that in terms of gold the value of the rupee had fallen by about 40 per cent from September 1931 to the end of 1938

The critics of 1*s* 6*d*. ratio included important Indian commercial and agricultural interests besides politicians and economists.[2] They considered the existing ratio highly injurious to India and would have it reduced to 1*s*. 4*d*. ster-

[1] Even earlier than this the Herschell Committee in 1893 had considered the proposal of the Government of India that English coinage should be made legal tender in India at a rate of not less than 13½ rupees for one sovereign (roughly 1*s* 6*d* Re) but had recommended that the ratio between gold coin and silver rupees should be fixed in the first instance not much above the rate then prevailing i e , 1*s* 4*d* to the rupee, though they said that if circumstances required it, the Government of India might be empowered to raise it with the sanction of the Secretary of State (*Report*, paras 40 and 150). At that time the question was not a controversial one

[2] For an illuminating academic discussion of the ratio question, see *The Sankhya, Journal*, March and September 1937, and November and December, 1938 See also *Economic Problems of Modern India* Vol. II (edited by R. K. Mukerjee and H L Dey), Chaps XXVI—XXVIII

ling or even a lower figure if necessary The demand for devaluation of the rupee was before September 21, 1931 a demand for lower value of the rupee in terms of gold but was later on, when sterling had no longer a fixed relation to gold, a demand for lower value in terms of sterling

The devaluation of the rupee involved so many issues and touched so many interests that it was not easy to venture a categorical pronouncement in favour of or against it An attempt to understand the issues as they were discussed during the years 1931-39 might be made by finding answers to four questions—

1 What should be the object or objects of currency policy in India?

2. How far can that object be achieved by currency policy alone (*i e*, unaided by measures of another kind)?

3 Has stabilisation of exchange rate at 1*s* 6*d* failed to secure that object? What evidence is there that it has failed to do so?

4 If 1*s* 6*d* ratio has failed to do so, can devaluation of the rupee secure it? If so, what should be the extent of devaluation?

There will be general agreement that the objective of currency policy in India should be determined with reference to her economic position India has been a debtor country with a vast rural population, large internal trade and struggling industries As a debtor country she had to meet foreign obligations amounting to more than £32 millions An exportable surplus of merchandise of that amount at least had to be maintained year after year The alternatives were to export precious metals or to raise foreign credits The interests of the vast rural population demanded that prices of agricultural produce should cover the expenses of agricultural production The growing industries required protection from foreign competition and the large internal trade had to be saved from violent strains due to forces originating outside the country

As a debtor country India had naturally to attach great importance to the stability of the exchange value of the rupee Small changes in exchange ratio might cause big differences in

the amount of foreign remittances It could not be maintained, however, that an *exportable surplus* to meet foreign obligations could under all circumstances be maintained by keeping exchange stable Currency might have to be devalued and was actually devalued by several countries to rectify an unfavourable or falling balance of trade. Otherwise, too, rigid stability of exchange was too narrow an objective for a country like India with a large rural population and internal trade An exchange kept rigidly fixed was bound to be a good conductor of disturbances occurring in the outside world It would expose the internal economy of the country to the stress and strain of external forces. In a very much disturbed world, exchange rate had to be used as a "shock absorber" of price disturbances occuring outside the country so that the prices inside the country might remain in level with costs and production and employment might follow a steady course For India the maintenance of stable cost-price parity appeared to be a much more desirable objective than mere stability of exchange An exchange rate that secured adjustment between world prices and internal prices was not enough unless the internal prices were also brought into level withinternal costs. It was obvious that no exchange rate rigidly clung to could secure that object.

It would have been claiming too much for currency policy to say that it alone could secure stability of production and employment. Currency policy by itself cannot rectify all maladjustments in the economic organization of a country.[1] Yet it is a powerful instrument which if wielded at a psychological moment can 'stop the rot' caused by an incipient or even deep depression and stimulate industries and trade. In Australia this instrument was used to the best effect and admirable results were obtained It is true that certain special conditions in Australia such as the greater flexibility of wages and, therefore, cost of production made currency devaluation effective. But good results could be secured elsewhere also if

[1] 'The entire economic system cannot be controlled by operating a single lever, through monetary mechanism alone, but control of that lever is indispensable in the pursuit of balanced economic advance" A D Gayer in *Monetary Theory and Economic Stabilisation*, p 195.

the devaluation was well-timed

Ever since 1*s* 6*d* ratio was fixed in 1927, the Government expressed, reiterated, affirmed and reaffirmed their determination to maintain it and took all possible measures to that end In 1929-30 and 1930-31 they experienced difficulty in maintaining it and contracted currency to the extent of over Rs 40 crores The abandonment of gold standard by England relieved them of the task of maintaining 1*s* 6*d* gold rate The linking of the rupee to sterling was a disguised depreciation in relation to gold The pressure of inexorable forces thus made the Government adopt in September 1931 a course which they had refused to follow voluntarily The heavy contraction of currency during 1929-30 and 1930-31 was justified by Sir George Schuster as a consequence of slackness in trade [1] Even allowing for trade slackness, it appears that the currency contraction was made necessary by the attempt to maintain 1*s* 6*d* rate Those opposed to 1*s*. 6*d* ratio, thefore, pointed out that the maintenance of 1*s* 6*d* ratio had not only fully exposed Indian economy to world depression but actually intensified certain of its effects by accentuating the fall in internal prices The deflationary effects of the ratio had spread out like a heavy blanket over the Indian economy obstructing recovery and expansion

It was difficult to say how far there had been an adjustment between prices and costs during the 6 or 7 years between 1932 and 1938 and whether in 1938-39 the rupee was overvalued The statistics available in this country about prices and costs are neither very accurate nor very reliable The information about changes in price level is based on Calcutta or Bombay index numbers of prices, the method of construction of which can be greatly improved There are no statistics directly relating to costs of production and use is, therefore, made of Bombay cost of living index number and statistics of agricultural wages (obtained from agricultural wages census reports) and of industrial wages (from other sources) to find out the trend of movements of costs—a procedure open to criticism It is clear, however, that while a definite tendency towards a marked rise in the index numbers of wholesale

[1] Address to the Conference of Finance Secretaries, October 1930.

prices was noticeable in the United Kingdom, U. S A. and other countries after 1934, Indian prices exhibited no appreciable rise. The following table shows the movements of prices in India and a few other countries—

Index numbers of prices 1929=100

	1930	1931	1932	1933	1934	1935	1936	1937	1938
U K (Board of trade)	87.5	76.8	74.9	75.0	77.1	77.9	82.7	95.2	88.8
U S A	90.7	76.6	68.0	69.2	78.6	83.9	84.8	90.6	82.5
Australia (Melbourne)	88.5	79.2	78.3	78.2	81.6	81.5	85.6	91.9	92.2
Japan	82.4	69.6	73.3	81.6	80.8	84.4	89.9	108.4	114.3
Canada	90.6	75.4	69.8	70.2	74.9	75.4	78.0	88.4	82.2
India (Calcutta)	82.3	68.1	64.5	61.7	63.1	64.5	64.5	72.3	67.6

It was possible that the disparity between the price level in India and abroad was due to (1) heavier fall in agricultural prices and their halting upward movement and (2) rearmament programmes of several countries which led to a spurt in prices. Any persistent failure of Indian prices to catch up to world prices would, however, have to be attributed to *1s. 6d* ratio. Even if it could be established that this failure was not due to *1s. 6d* ratio, there still remained a case for devaluing the rupee to initiate a rise in prices to benefit the vast agricultural population.

An important argument advanced against devaluation of the rupee was that a measure of stability in international exchange relations had already been attained and India should not cause a disturbance just then by devaluing the rupee. It might be pointed out, however, that the disturbance might not have been so great as was feared and it would have been worth while to risk some of it in the interests of the agriculturists who form the bulk of population Intensive enquiries in rural areas showed that at the prevailing level of prices the agriculturist could not meet his costs (including in "costs" ordinary wages and some return for enterprise). Many of the agriculturists' costs such as rent, land revenue and maintenance charges of livestock are more or less fixed and did not fall in proportion to the fall in prices. If agriculture had been a business and not a way of life in this country, many of those

engaged in agricultural production would have closed the shop long ago That they did not do so or could not do so was no reason why they should not have been put in a position to meet their costs. Any relief given to agriculturists was bound to have a tonic effect on the entire economic system of the country

There could be difference of opinion as to how far devaluation of the rupee would stimulate our exports The linking of the rupee to sterling at 1*s* 6*d* and the consequent depreciation of the rupee in relation to currencies based on gold did raise prices a little in India Some advantage was secured in export trade with those countries which still remained on gold standard such as France, U S A, Italy and Germany but this advantage was largely neutralised on account of the imposition by these countries of high tariffs, quota systems and exchange restrictions and currency devaluation. It was highly problematic if any devaluation of the rupee would have stimulated demand for our exports or secured a passage for them through the iron bars of numerous trade restrictions It might, on the other hand, have led to competitive depreciation of currencies by other countries or retaliation in some other form This danger could to some extent be mitigated by entering into trade agreements on the basis of a devalued rupee, if on other grounds devaluation was found desirable As regard exports to countries of the sterling group, even a temporary improvement in trade could not be secured owing to the maintenance of the old rate of 1*s* 6*d*. A lowering of exchange rate to stimulate exports to these countries was subject to the same risk of retaliation On the whole it would appear that no lasting increase in our exports could be secured without a general revival of world demand for them This in turn depended upon the relaxation of international tension and the removal of barriers to international trade Devaluation would, however, have enabled India to maintain or strengthen her competitive position in the world markets in some articles of export

The devaluation of the rupee could be used as a lever to raise internal prices The prices of exports and imports would have risen first and the rise might have slowly spread

to other commodities which did not enter into India's foreign trade. This would have stimulated production and trade. It was pointed out, however, that while the rise in prices of exports might take time in percolating to the primary producer, the price that he had to pay for imported goods would immediately increase. The Indian agriculturist would, therefore, obtain no advantage from the devaluation of the rupee If his costs rose as fast as prices, it was clear that no net benefit could accrue to him. A plausible reply given to this argument was that most of the farmer's costs did not depend on the prices of imported goods inasmuch as such goods formed only a small part of the agriculturist's consumption and in any case there was bound to be a time lag between the rise in prices and rise in costs. The agriculturist could obtain the benefit of this time lag

A rise in the prices of imports was, no doubt, undesirable from the point of view of the consumers. It should not have been overlooked, however, that consuming is not the sole function of consumers, they also work and produce If opportunities for work and production are enlarged, the burden of slightly higher prices is lightly borne by the consumers A rise in the prices of imported goods would also have given added protection to Indian industries,[1] particularly those which did not come under the scope of the policy of discriminating protection It could not be ignored, however, that the protection given by currency devaluation is indiscriminate and could be justified only if the Government policy was so halting and vacillating that indiscriminate protection was the only alternative to inadequate protection

The existing position with regard to exports and imports could hardly be called healthy and normal The merchandise balance of trade in favour of India (including Burma) amounted to about Rs 43 crores in 1937-38 as against Rs 78 crores

[1] In the case of large scale manufacturing industries devaluation was advocated not as a measure of addition protection but to remove the handicap of an over-valued currency under which they had been labouring since 1927 It may be noted, here, that devaluation would have raised the price of imported machinery, appliances and stores and to that extent handicapped Indian industries

in 1936-37. This was primarily due to an increase in imports Excluding Burma, the balance of trade in favour of India in 1937-38 was only Rs 16 crores in 1937-38 against Rs 52 crores in 1936-37 It is said that "in fact the best proof of a well-chosen ratio consists of its harmony with a steady and moderate price level and a healthy and normal condition of imports and exports"[1] If this be the proof of a well chosen ratio, 1*s.* 6*d* ratio could hardly be said to have furnished it.

The fall in prices in India not only upset price-cost parity, thus damaging production and increasing unemployment but also brought about profound disturbances in distribution. It strained relations between debtors and creditors, landlords and tenants (particularly those paying contract cash rents), employers and workers and gave too arbitrary an advantange to men with fixed or gradually increasing income such as the Goverment employees or pensioners A rise in prices, if it could be brought about through devaluation, would not only have taken a load off the productive activity but also eased in great measure class relations The interests of different classes might diverge upto a point but just as depression ultimately overwhelms all alike,[2] any lifting of it would have brought, sooner or later, relief to all

An important interest to consider in any discussion of the ratio was the Government of India who had to remit annually Home charges amounting to about £32 millions A reduction in exchange rate by two pence would have increased the burden of Home charges by about Rs 6 crores and upset the budgetary equilibrium and credit of the Government of India. The Hilton Young Commission said that this was not a "decisive factor" It could not, however, be ignored A decrease in central revenue might not only have made fresh taxation necessary but might have also put a stop to the distribution of the provincial share in the proceeds of income-tax All this followed from a short range view of the matter and if this view alone had to prevail, the argument against an

[1] J C Covajee in *The Asiatic Review*, Vol XXV, p 412

[2] This is shown by the condition of agricultural debtors and money-lenders both of whom suffered, the latter through inability to recover even interest, not to speak of the principal lent.

alteration of the ratio was strong It stood to reason, however, that the fall in central revenue due to devaluation might have been more than covered by increased receipts from income-tax, railway contributions, customs etc , which a rise in prices and general trade revival would have brought about.

Devaluation of the rupee, it is true, could give only a temporary stimulus to prices Devaluation is never a get-rich-quick device But when a country is emerging from the nadir of depression it requires just that temporary stimulus to put it on the way to recovery. Devaluation is also a defensive weapon which may be used to protect internal economy. For permanent results, however, remedies of another kind which would increase productive efficiency and lower costs of production must be applied. Devaluation is no panacea for economic ills. Furthermore, currency is a delicate instrument and when it is used to achieve non-monetary objects, it has to be used with care and precision The time and manner of its use must be properly judged. Perhaps it could be used to the best effect in India in 1931 and later on in 1933 or 1934.

ADDENDUM TO §6

The Latest Phase in Ratio Controversy

The ratio controversy entered a new phase and assumed a political complexion towards the end of 1938 The Working Committee of the Indian National Congress passed the following resolution on 14th December, 1938 .—

" Since the fixation of the ratio at 1*s.* 6*d* to the rupee all trade interests in India and public bodies have protested that this measure is against the vital economic interests of India and have insistently demanded its revision. The Government of India have hitherto resisted all these attempts and last issued a *communique* on June 6, 1938, declaring that it did not intend to make any change in the ratio for the time being and in support of that declaration sought to rely merely on the instability and uncertainty during the period of readjustment which, according to them, was likely to cause greater loss to Indian interests than any corresponding gain from the change to a lower

ratio Since June last the balance of trade has turned more and more against India The Committee are of opinion that the rate of 1s 6d to the rupee has hit hard the agriculturist of this country by lowering the price of agricultural commodities and given an undue and unfair advantage to imports into this country The Working Committee is satisfied that the rate of 1s 6d cannot any longer be maintained by large exports of gold which have been very injurious to the country Matters have now reached a stage when the rate can only be maintained by a policy of contraction of currency and credit and by further depletion of the gold and sterling resources of India and particularly the Paper Currency Reserve Those sterling resources have already been used up to an alarming extent and there is a danger of further serious depletion taking place if efforts continue to be made by the Government of India to maintain the present ratio The Working Committee look upon such prospect with the utmost concern and anxiety In view of this situation the Working Committee have come to the conclusion that the best interests of the country demand that efforts to maintain the present exchange level should henceforth cease and urge upon the Governor General-in-Council the necessity of taking immediate steps to lower the rate to 1s 4d to the rupee"

The Working Committee's criticism of the Government policy in maintaing 1s 6d ratio could be reduced to the following —

1 Since June 1938, the balance of trade had turned more and more against India, indicating the unnaturalness of the ratio under the existing economic conditions.

2 1s 6d rate had hit hard the Indian agriculturist by lowering the price of agricultural commodities

3 1s 6d rate had given an undue and unfair advantage to imports into India

4 1s 6d rate could be maintained only by contraction of currency and credit and further depletion of gold and sterling resources

5 Sterling resources had already been used up to an

alarming extent to maintain the ratio.

The Government of India issued a *communique* on the 16th December 1938, disputing the facts and countering the arguments set forth in the Working Committee's statement It ran as follows —

> "The Government of India wish to make it clear that they have no intention of allowing a lowering of the present exchange value of the rupee On the contrary, they intend to defend it by every means in their power and are confident of their entire ability to maintain it.
>
> It is said that since their previous declaration of June 6, 1938, the balance of trade has turned more and more against India. The fact is that, in every month since June the balance of trade, even excluding treasure, has been in favour of India and to an extent greater than in the corresponding month of the previous year.
>
> It is said that the sterling resources of India, particularly those of the Paper Currency Reserve, have been used up to an alarming extent. The facts are that the assets of the Paper Currency Reserve were merged in those of the Reserve Bank in April 1935, and that the gold and sterling resources of the bank are as high now as they were at the time of its inception and are in any event more than 50 per cent of the total liabilities as opposed to a statutory requirement of 40 per cent only Moreover, since the inception of the Bank, 60 crores of sterling debt have been repatriated
>
> It is said that the 1*s* 6*d* ratio has hit hard the agriculturist by lowering the price of agricultural commodities. The fact is that, since June last, the trend of the price-index of the chief articles of export has been definitely upwards
>
> The Government of India are convinced that a lowering of the ratio in the existing international market conditions would produce no appreciable rise in what the cultivator can realize for his produce They are equally convinced that it would produce an immediate rise in the cost of what he buys.
>
> It would also seriously weaken the budgetary position of the Central Government and the larger Provincial

Governments

In fact, a lowering in the ratio would do no good to anybody except the moneyed and speculative interests who profit from conditions of uncertainty and disturbance or who secure an additional but unseen all round increase of 12½ per cent in the protection afforded to them at the expense of the consumer

Altogether the Government of India have no doubt that it is their clear duty in the interests of India generally and the cultivator, in particular, to defend the present ratio to the utmost of their power As already stated, they have every belief in their ability to do this and they are confident that drastic measures of contraction will not be necessary, except to the extent that they are forced on them by the action of speculators who place their funds abroad in the hope of bringing them back at a profit Incidentally, they are convinced that the exchange would be materially stronger to-day, were it not for the fact that there have been large movements of funds to the United Kingdom by these same speculative interests during the last year "

The Government *communique* was cleverly worded and, while exposing to attack the weak points in the Working Committee's statement, concealed many weaknesses in the position it sought to defend It was, for example, true that from June to October 1938, the balance of trade had been in favour of India to even a greater extent than in the corresponding period of 1937 But the period of 1937 did not furnish the correct basis for comparison , for during it imports had been stimulated by the preceding boom conditions and the balance of trade had begun to shrink A comparison with conditions in 1936 or three or four years preceding it showed considerable fall in the total visible balance of trade

The *communique* pointed out that the price-index of chief articles of exports had an upward trend since June, 1938. The trend was, it may be said, not well-marked and in any case the rise of agricultural prices during the previous four years of recovery had been painfully slow and inadequate

The Government met the argument that 1*s* 6*d* ratio had

given an undue advantage to imports into India by a counter-argument that a lowering of the ratio would only benefit those who would secure 12½ per cent increase in the protection afforded to them at the expense of the consumer (meaning the Indian industrialists) or those speculators who profited from instability in exchange

The Government denied any depletion of the resources which were available to maintain exchange. Actually, however, the sterling balances of the Reserve Bank had fallen and the sterling assets of the Bank could not have been maintained unimpaired but for gold exports

The Government attributed the weakness of exchange to the speculative movement of funds outside the country and expressed confidence in their ability to maintain the ratio without contraction of currency The weakness in exchange, it is unnecessary to emphasize, is generally due to causes more fundamental than the action of some speculators and unless an adaptation to the fundamental shift in economic conditions is brought about through devaluation, contraction of currency has to be resorted to

The arguments given in the *communique* against devaluation were *firstly*, it would produce no appreciable rise in the prices of agricultural products and would, on the other hand, raise the costs of the farmer, *secondly*, it would seriously weaken the budgetary position of the Central Government and the larger Provincial Governments, *thirdly*, it would benefit nobody except " moneyed and speculative interests " and Indian industrialists

These arguments were familiar enough and have been dealt with in §6

CHAPTER X

IX Period September 1939—August 1943

CURRENCY DURING THE SECOND WORLD WAR

§1 ON THE EVE OF WAR

On the eve of the outbreak of War, there were, broadly speaking, three open questions of Indian currency, *viz.*, suitability of the currency standard, correctness of the exchange ratio and the desirability of gold exports, the first two having a much longer history behind them than the third Discussion about all three of them had lost none of its liveliness in the first half of 1939, though it was not keyed in the same high pitch of controversy as in the years between 1931 and 1938 There were, of course, reasons more substantial than mere love of polemics, for this controversy not being laid finally to rest The reasons were, firstly, that neither the economic developments in the international sphere nor the economic conditions within the country had furnished any firm evidence in favour of the view that sterling exchange standard, 1*s* 6*d* ratio and gold exports were more beneficial than harmful to the country's interests, secondly, that the government had consistently refused to reconsider or modify in any way the decisions they had once taken on these questions It appeared, therefore, that only a major catastrophe like a war would clinch the issues and bring about their reconsideration by effecting a radical transformation in the economic *milieu* But wars do not generally solve old problems except by raising new ones and, so far as the outstanding Indian currency problems are concerned, the present war may be said to have solved the old ones only by casting them into the background and raising new ones

§2. Rupee-Sterling Ratio

The demand for finding a suitable exchange parity of the rupee, other than 1*s*. 6*d* rate, lost all its force after the outbreak of the war 1*s*. 6*d* rate had never been firmly established ever since its adoption in 1927 and the linking of the rupee to sterling and the consequent conversion of 1*s* 6*d* gold rate into 1*s* 6*d* sterling rate at a time when sterling was depreciating in relation to gold amounted to a disguised devaluation of the rupee in terms of gold And though for some years after 1931 the exchange firmed up, its strength was derived mainly from the adventitious aid of gold exports When gold exports began to decline in volume and the balance of trade began, after June 1938, to turn more and more unfavourable to India, the exchange began to show signs of weakness Since September 1939, however, it has been, on the whole, very steady, finding solid support from a very favourable balance of trade as well as from intensive measures of trade and exchange control When, for instance, the forward exchange rates weakened in the early weeks of war, the Reserve Bank took the unprecedented step of entering the forward market and announcing its readiness to purchase sterling for forward delivery at a rate somewhat higher than its spot buying rate This had the effect of steadying the market

As the rupee-sterling rate and the balance of trade have normally a close relation to each other, the state of trade balance may be referred to here in passing The total balance of trade in merchandise of India and Burma together (for the two have formed one unit for currency and exchange purposes) was +Rs 20 12 crores during April-August 1939 and +Rs. 56 94 crores during September 1939-March 1940 as against +17 51 crores and +25 70 crores in the corresponding periods of 1938-39 During the four years from 1939-40 to 1942-43, the balance of trade in merchandise of India and Burma together has varied as follows[1] .—

[1] *Review of the Trade of India in 1940-41*, p 83

Period	Balance of trade (in crores of rupees)
1939-40	+78·02
1940-41	+68·54
1941-42	+79 88
1942-43	+83 37

Since the beginning of the war, the rates of Telegraphic Transfers from Bombay on London have remained in the neighbourhood of 1*s* 6*d* and the amount of sterling purchased by the Reserve Bank has steadily increased From August 1939 to March 1940, the Bank made record purchases of sterling of the total amount of £70 5 million, in 1940-41, 1941-42 and 1942-43, the purchases amounted to £57 1 million, £73 3 million and £91 7 million respectively at an average rate of 1*s* 6*d* In addition to these open market purchases, the Reserve Bank also received large amounts of sterling on account of the purchases made by the British government in the Indian market Two other notable items accounting for the receipt of sterling were gold and silver exported and sold abroad and the grants received from the British Government for the modernisation of the Indian army The sterling holdings of the Bank have considerably increased and even after the utilization of sterling for repatriation schemes and for meeting other sterling commitments, the holdings were valued at Rs 511 crores at the end of March 1943

Attention may be drawn here to one significant aspect of the rupee-sterling exchange the fixed rupee-sterling rate with a very favourable balance of trade has been conducive to a large rise in prices in India The balance of exports over imports has been paid off by the issue of fresh rupees against sterling accumulations in England An exchange rate left free to rise in response to a favourable balance of trade would have operated to some extent as an automatic corrective by discouraging exports and would have to that extent checked the rise in internal prices Even if exports were not discouraged, it would have involved a smaller issue of rupees in India against a given amount of sterling received in payment for exports The contrast between a rising exchange

during the last war[1] and a fixed exchange during the present war is of considerable interest

§3 EXCHANGE CONTROL

The institution of exchange control is one of the most important wartime developments in the Indian currency system Provision for it was made in the Defence of India Ordinance promulgated on the outbreak of war, the Financial Provisions in Part XIV of the Ordinance providing, *inter alia* for —

(*i*) restrictions on purchases of foreign exchange,

(*ii*) acquisition by the Central Government of foreign exchange,

(*iii*) restrictions on purchases and export of securities, and

(*iv*) acquisition by the Central Government of foreign securities

The powers taken by the Government of India in these matters were delegated by them to the Reserve Bank of India On the 4th September 1939, the Bank issued an explanatory memorandum to the public giving the general lines of exchange control instituted in India[2] All dealings in foreign currencies including sterling were now required to be made through only such dealers as were authorized by the Reserve Bank to deal in foreign exchange Transactions in the currencies of the Empire countries (with the exception of those of Canada, Newfoundland and Hong Kong) were to be free from any restriction but those in non-Empire currencies were restricted to genuine trade purposes, travelling expenses and small personal remittances All transactions were to be done on the basis of the rates quoted by the London Exchange Control combined with the current rupee rate of exchange

Although the exchange control has been operated on the general lines indicated above, modifications and changes in the original system had to be made, as the war dragged on, to meet the ever present need of conserving foreign exchange

[1] *Vide*, p 38

[2] *Economic Resources Board Statutory and other Notices*, pp 59-66 and *Reserve Bank Report on Currency and Finance* 1939-40 pp 10-11

l functions of the Reserve Bank regarding exchange control : now directed by the Exchange Control Department :cially organised in October 1939 and working under the rect supervision of the Governor of the Bank Develop-ents since the exchange control was instituted in September '39 are too numerous to be mentioned in detail but the ief among them can be grouped under the following broad :adings —

(i) *Extension of free sterling area*

The free sterling area *i e*, the area within which funds iove freely, constituted as it is by all the countries in the ritish Empire excluding Canada, Newfoundland, Hong ong, the mandated territories, Egypt and Iraq, has been ctended by the inclusion of Belgian Congo, Free French rritories, Iceland and Foroe Island, Syria and Lebanon and Iadgascar and its dependencies

(ii) *Restrictions on the disposal of foreign exchange*

Under an Export Control Scheme which covers all the xports, the value received for exports in foreign (non-sterling rea) currencies has to be utilized in a manner approved by he Reserve Bank[1] The scheme ensures that the foreign :xchange proceeds are not retained abroad and the regulations of the London control in the matter of official rates at vhich currencies are dealt in are not evaded[2]

[1] The despatch of parcels from India to any place outside the sterling irea has also been subjected to a similar system of control

[2] In the early months of the War two rates for sterling in terms of dollars came to be quoted—the controlled rate of the London Exchange Control and the free sterling rate The latter was the rate of the free market and was lower than the former The unfavourable consequence of the simultaneous existence of the two markets in sterling for India was that payment was received for those of her exports to which controll-ed rate did apply at the rate of one £ or Rs 13-5-4 for every $4 02 worth of goods while at the free sterling rate of $3 50=£1=Rs 13-5-4 the same goods worth $4 02 would have brought to the Indian exporter 12 per cent more in terms of rupees Payment for the exports of goods to which the controlled rate did not apply was on the other hand received hrough the free sterling market The East India Cotton Association drew the attention of the Reserve Bank of India to this matter (*vide Statesman* dated May 3 1940 for a summary of the correspondence be-

Under a system of import restrictions introduced since 20th May 1940, the sales of foreign currencies, especially those of 'hard currency' countries,[1] have been severely restricted to payments for licensed imports and a few private remittances[2]

(*iii*) *Acquisition of dollar balances and securities*.

Dollar balances held in United States by the residents in India as also the holdings of such residents in certain American securities have been acquired, rupee equivalents of the amounts acquired having been paid out by the Reserve Bank

(*iv*) *Restrictions on exports and imports of coins, currency notes etc* .

To prevent any person getting round the exchange control regulations by taking cash and jewellery out of India, limits have been laid to the extent to which they can be taken out. Since November 1940, the export from India of any currency notes or coins, whether Indian or foreign, except under a license from the Reserve Bank has been prohibited. Taking out of gold in any form from India without the permission of the Reserve Bank has also been prohibited.

Restrictions on dealings in the Bank of England notes were imposed in September 1940 and further tightened in October 1941 with the object of preventing any market developing in such notes smuggled from the enemy-occupied territories Since September 1942, the import of all currency or bank notes other than the Reserve Bank and Government of India notes issued in India,[3] Ceylon rupee notes, Iranian rials and Afghanis has been prohibited, except with the permission of the Central Government or the Reserve Bank of India The import and export of Russian rouble notes have also been pro

tween the Association and the Bank) By the Export Control Scheme the free sterling market was gradually eliminated

[1] The term 'hard currency' is used for a currency which is based on gold or is linked to a currency based on gold *e g* U S A dollars and swiss francs

[2] It need hardly be laboured that restrictions on and control of exports and imports are essential adjuncts of exchange control In fact trade control and exchange control reinforce each other and one would not be so very effective without the aid of the other

[3] *i e* the import of Burma notes of the Reserve Bank has also been brought under control

ibited in accordance with the regulations in force in J S S R

(v) *Restrictions on Chinese and Japanese accounts in ndia*

With a view to assisting China to conserve her supplies of oreign currency, restrictions have been imposed on the operations of the accounts held in India by the nationals of Free China Regulations have also been framed with the same object to ensure that the full proceeds of the imports rom China are credited to the account of banks approved or the purpose

The balances of all Japanese companies and firms resident n India were frozen on the 28th July 1941, i e, they could not be used except with the permission of the Reserve Bank of India. After the outbreak of the war with Japan in December 1941, all Japanese accounts were taken over by the Custodian of Enemy Property At the beginning of 1942, the accounts of persons and firms resident in Japanese occupied territories such as Hong Kong, Malaya, Netherlands East Indies and British possessions in Borneo were frozen and could not be operated without the permission of the Reserve Bank

(vi) *Restrictions on remittances of profits*

The remittance of profits and royalties by companies operating in India to any person resident outside the sterling area has been subjected to license since October 1941 with a view to restricting the amount of such remittances

All these measures of exchange control were designed to subserve the general objective of war economy, namely, the fullest economic mobilisation of the country Their main purpose was to raise the economic potential of Allied war effort by acquiring, conserving and utilizing in the best possible manner all resources in foreign exchange Subsidiary to this but no less essential was the introduction of every possible safeguard against the use by the enemy of any assets within the country Other wider considerations have been the economising of shipping space by cutting out non-essential exports and imports, the working out of a system of priorities by which the more urgent trade transactions precede the less urgent and the conserving of productive capacity in countries

like U S. A for essential war purposes.

The various restrictions, regulations and scrutinies which make up the system of exchange control must necessarily cause a good deal of inconvenience to those engaged in legitimate foreign exchange dealings Their application may sometimes be associated with considerable red-tapism, delay, favouritism and abuse The general efficacy and effects of exchange control in India, as elsewhere, can be properly appraised only after the war is over but it is obvious that the successful operation of the system in war as well as in peace requires an extremely high degree of state interference with, and control of, all branches of economic life. The State not only prevents exporters from disposing freely the proceeds of their sales abroad, but also allots the available supply of foreign exchange according to criteria which it frames and modifies in the light of experience and necessity [1] Its decisions regarding the apportionment of foreign exchange have a vital bearing on the whole economic organisation of the people For, it may favour certain home industries, manufacturers, or firms at the expense of others and bring about a redistribution of income among the different sections of the people and thus alter the entire economic set-up of the country The effects of wartime exchange control may not be so apparent as of several other economic developments but among the various elements that have gone towards the making of Indian war economy, exchange control has already found a prominent place When peace returns and the national economic systems released from the zariba of restraints and controls are allowed to have freer inter-communication, the retention or relaxation of exchange control—and the extent of it—will be one of the most immediate issues to be faced

§4 CURRENCY CIRCULATION, PUBLIC FINANCE AND PRICES

Among the various wartime developments in the sphere

[1] For a short and objective account of the pre-war system of exchange control *vide* League of Nations *Report on Exchange Control*

of Indian currency, the enormous expansion of currency overshadows all others by its spectacular character, its wide sweep and its direct impact on the daily life of the common man Its actual effects have been fairly serious but of greater moment perhaps is the potential threat that it holds of disrupting the entire fabric of Indian economy The analysis made of its underlying causes and the conclusions reached regarding its character and the extent of its seriousness by different groups of thinkers in the country have brought into sharp relief three conflicting points of view about the character, magnitude and consequences of currency expansion These viewpoints are those of the economist, the Government and the businessman The weighty nature of this development as well as the controversy which it has provoked enjoins the most rigid adherence to facts and cautious analysis in dealing with it

Currency circulation—volume and velocity

The total effective supply of currency in India is constituted by the amounts of Government of India (mainly one rupee) notes, Reserve Bank of India notes, rupee coin and small coin and demand deposits of banks, combined with their rapidity of circulation This total has to be picked to pieces to examine the change that has occurred in each constituent during the war and to obtain a correct idea of the magnitude of the total change

The Reserve Bank of India notes of the denominations of Rs 2, 5, 10, 100, 1,000 and 10,000 constitute by far the most important part of currency circulation in India Deposit currency not having developed in India to any appreciable extent owing to insufficient growth of banking and banking habits, bank notes and coin form the most widely used media of exchange In August 1939, the total amount of notes (including Government of India notes of mainly Rs 50 and Rs 500) in active circulation stood at a little less than Rs 179 crores By August 1943 it had increased to Rs 755 crores, *i e*, by over Rs 570 crores or 322 per cent [1] This phenomenal increase was, however, not accomplished by easy stages

[1] The figure for December 1943 is 840·8 crores

or at a steady and uniform rate, as the following figures will show.—

Year	*Month*	*Notes in circulation** (in crores of rupees)
1939	August	179
1940	February	240
	May	249
	October	229
1941	January	245
	August	277
1942	January	356
	August	474
1943	January	593
	August	755
1944	January (21)	854

In the first six months of the war, note circulation expanded at a more or less steady pace by about 60 crores, it increased further by another 9 crores during the next three months but fell off between May and October 1940 by about 20 crores, so that the net increase upto October 1940 amounted to only 50 crores From the level reached in October there has been an unbroken rise, the increase amounting to about 50 crores by August 1941, another 200 crores by August 1942 and a further 280 crores by August 1943.

A different way of representing the increase is to divide it into units of 50 crores and set it against the approximate number of months in which it was accomplished

Magnitude of increase	*Period*	*Number of months*
1st 50 crores	September 1939—November 1939	3
2nd ,,	December 1939—September 1941	22
3rd ,,	October 1941—December 1941	3
4th ,,	January 1942—February 1942	2
5th ,,	March 1942—May 1942	3
6th ,,	June 1942—September 1942	4

* These figures are for the last Friday of each month and have been taken from statement XXXII of the *Report on Currency and Finance* for the year 1942-43 and the *Monthly Statistical Summary* of the Reserve Bank Figures for 1942-43 exclude Burma notes

Magnitude of increase	*Period*	*No. of months*
7th ,,	October 1942—November 1942	2
8th ,,	December 1942—January 1943	2
9th ,,	February 1943—March 1943	2
10th ,,	April 1943—May 1943	2
11th ,,	June 1943—July 1943	2
12th ,,	August 1943—October 1943	3
13th ,,	November 1943—December 1943	2

It is clear that after an initial briskness lasting for the first few months of the war period, the pace of expansion of currency considerably slackened, only to quicken once again from September 1941 and develop into something like a gallop from September 1942

Turning now to the Government of India notes, they form only a negligible fraction of the note circulation and consist now mostly of one-rupee notes (issued since July 1940) which occupy a peculiar position in the currency system in that while notes of bigger denominations are convertible into them, they themselves are not convertible into rupee coin and are treated in the assets of the Reserve Bank like rupee coin [1] As the convertibility of notes of higher denominations into rupee coin has been considerably restricted during the war, whole of the note-issue may be described as inconvertible for all practical purposes Statistics for the one-rupee issue are not furnished separately but are merged in those of rupee coin circulation

Besides the enormous expansion in the circulation of currency notes noted above, there has also been a large increase in the absorption of rupee coin as well as small coin during the war The total absorption of rupee coin (including one rupee notes) from the outbreak of the war to the end of August 1943 amounted to Rs 117 crores, being composed as follows —

Year	*Rupee coin absorbed* (in crores of rupees)
September 1939—March 1940	19 53
1940—41	33 22
1941—42	7 17

[1] Government of India notes of the denominations of 50 and 500 are also in circulation the Reserve Bank having decided not to issue such notes

Year	*Rupees coin absorbed* (in crores of rupees)
1942—43	6·09
April 1943—August 1943	10·80

No less striking is the absorption of small coin (including half rupees) of silver, copper and nickel—which amounted from the outbreak of war to August 1943 to Rs. 30·2 crores, the amounts absorbed in different years being as follows :—

Year	*Small coin absorbed* (in crores of rupees)
September 1939—March 1940	2·64
1940—41	4·28
1941—42	5·06*
1942—43	11·64†
April 1943—August 1943	6·60†

Finally, the bank deposits, too, which form a significant part of the media of payment, have recorded considerable increase. The only deposits relevant in this connection are those subject to cheque, namely, demand deposits. Figures for such deposits are available for the scheduled banks and are given for the war period below. The total increase in these deposits since the war started upto August 1943 was about 302 crores[1] of rupees of which about 100 crores are accounted for by the twelve months from September 1942 to August 1943.

Year	*Month*	*Amount of demand deposits* (in crores of rupees)
1939	August	135·5
1940	February	137·1
	May	140·2
	October	161·8
1941	January	169·2
	August	195·4
1942	January	217·0
	August	294·7[2]
1943	January	344·7
	August	437·8
1944	January (15)	505·4

* Excluding Burma for February and March 1942

† Excluding Burma

[1] Upto December 1943 the increase was Rs. 365 crores

[2] Burma figures have been excluded since February 1942

Velocity of currency circulation

Thus the increase in all the various media of payment uring the four years of war totals up to nearly 1019 crores of upees of which note circulation accounts for 570 crores, upee coin, 117 crores, small coin, 30 crores and bank demand) deposits, 302 crores But to find out the really *ffective* increase it is not enough to know the quantitative ncrease, the rapidity of turnover of the media of payment nust also be taken into consideration Here, unfortunately, no reliable information is forthcoming and while an approximately correct idea of the velocity of circulation of bank deposits can be formed from the Clearing House Returns, the velocity of note circulation remains wholly a matter of conjecture The velocity of bank deposits has distinctly declined during the last four years as shown in the last column of the table below[1] —

(*In crores of rupees*)

Period	*Average demand deposits*	*Total Clearing House Returns*	*Number of times 3 to 2*
1	2	3	4
1938—39	123 8	1,929	15·6
1939—40	132 6	2,211	16·7
1940—41	155 8	2,019	13 0
1941—42	201 9	2,569	12 7
1942—43	306 3	2,773	9 1
April—Aug, 43	407 9	1,688 (4051)[2]	9 9[2]

It may be inferred from this in a rough and general way that the rapidity of note circulation also showed a similar decline Among the several reasons that can be adduced for this decline in the activity of money, probably the foremost is the strong propensity towards hoarding of rupee and small coin engendered by the uncertain conditions of war To this has been added the higher preference shown by the people, banks and business houses for liquid positions and, consequently,

[1] It may be noted that while the figures in column 2 are for scheduled banks only, those in column 3 include the value of cheques of other banks also

[2] Annual rate

for holding idle cash balances The plethora of money in the money market combined with a paucity of suitable outlets for investment has been another contributory factor.

Currency circulation and prices

Contemporaneously with the heavy expansion in currency circulation, tempered as it has been by a somewhat diminished velocity, there has occurred a marked rise in the general level of prices Prices began to rise as soon as the war broke out and the first four months witnessed a strong upthrust of the price level After that there was a break and by July 1940 prices had subsided to a little higher than the pre-war level Soon after, however, they resumed their upward movement which became progressively quicker and steeper with the passage of time In the table below, the index numbers of prices, note circulation and demand deposits have been shown in juxtaposition

Year	Month	Note Circulation (in crores of rupees)	Demand deposits (in crores of rupees)	PRICES: Calcutta (August 1939=100)	PRICES: Bombay (July 1939=100)	PRICES: Economic Adviser's (Week ended 19th Aug 1939=100)
1939	August	179	136	100	103	100 3
	December	236	138	137	135	138 3
1940	January	238	139	130	128	133 2
	July	238	143	114	115	112 1
	October	229	162	121	115	112 1
1941	January	245	169	121	117	114 8
	August	277	195	151	144	142·5
1942	January	356	217	155	184	145·0
	August	474	295	192	228	161 1
1943	January	593	345	250	255	190 4
	August	755	438	345	258	238 4
	October	782	466	334	244†	‡

Thus while note circulation increased in four years by 322 per cent[1] and demand deposits by 222 per cent[2], the general level of prices shows, on the average, an increase of 200 per cent It may be pointed out that the index numbers of prices, being based on control prices, do not take account of the much

† Figure for September 1943
‡ Figure not available

[1] Upto Dec 1943 by 370 per cent.
[2] Upto Dec 1943 by 268 per cent.

higher black market prices prevailing for several commodities and, therefore, underrate somewhat the actual rise in prices

The facts set out above may now be summed up in three plain statements —

1 The various constituents of the monetary circulation have recorded a steep and progressive rise

2 The decline in the activity of bank demand deposits suggests a general fall in the velocity of circulation of money

3 The general level of prices has shown a large increase but has been outpaced by the increase in money supply

Inflation—character and development

It is this simultaneous occurrence of the expansion of currency and the rise in prices that has flung into focus the issue of inflation The co-existence of rapidly expanding currency and sharply rising prices furnishes under any circumstances a strong *prima facie* evidence of the existence of inflation but when a causal relationship can be established between the two by a reference to all the attendant circumstances, the evidence becomes irresistible and the conclusion inescapable that inflation exists The inflation issue in India has by now become the pivot round which every discussion of Indian war economy revolves and no account of wartime currency developments which fails to give it a prominent place can be really complete

Any discussion of the inflation issue in India gets down, sooner or later, to four basic questions *first*, what is inflation? *second*, what evidence is there that it exists in India? *third*, to what extent is it serious in magnitude and grievous in consequences? *fourth*, how can it be prevented or the severity of its effects mitigated?

There would appear to be two ways of looking at inflation as an inflationary issue and as an inflationary situation [1] An inflationary issue of currency may be said to occur when purchasing power whether in the form of paper currency or bank credit is expanded *beyond* the needs of trade, employ-

[1] A short explanation of the phenomenon of inflation has already been given in the Introduction (pp 11-14)

ment and production That is to say, so long as the expansion of purchasing power occurs *in response to* the expansion of trade, employment and production or *evokes* such expansion, it may not be called inflationary in character. It follows that an increase in purchasing power may not be described as inflationary so long as it is leading towards fuller utilization of resources, *i e*, towards a state of full employment Inasmuch as this increase will spend itself in bringing dormant and idle resources into activity, it will not result in a rise in prices until the state of full employment is reached This general statement may, however, be qualified by the proviso that a rise in prices of a sporadic character may occur, even before the state of full employment is reached, due to the development of bottlenecks, impediments and frictions which hamper the mobility of resources War usually leads to the stimulation, energising and mobilisation of resources, to the taking of 'slack' and the use of idle capacity. The expansion of economic activity it brings about may, not unreasonably, be compared to the boom phase of the business cycle It obviously demands an expansion of currency to facilitate and finance it But as soon as the expansion has performed this task, it becomes inflationary It is necessary to point out here that the state of full employment in the present context means not necessarily a state in which every unit of productive resources—every man, plot of land and machine—is employed but one in which the fullest employment possible under the circumstances of a country has taken place

An inflationary situation, on the other hand, may develop during war even when some of the resources are unemployed, *i e*, when there has been no inflationary issue as such This will happen when the total stock of purchasing power is not properly bifurcated so as to correspond to the volume of goods and services required for war purposes and of those required for civil consumption The increased income accruing from the increased employment of labour and other resources then exerts its pressure on the limited supplies of goods of civil consumption raising their prices To have a clearer picture of this situation, the economy of a country

during war may be visualised as having two sectors—the war sector and the civil sector Prosecution of war involves the use of a steadily increasing proportion of a country's real resources for military needs and of a steadily diminishing proportion to provide for civil consumption An expanding war sector and a contracting civil sector of economy give a new twist, as it were, to a country's economy and the total money supply, if it is not to become a disturbing factor, must facilitate and faithfully interpret this twist In other words, purchasing power must be drained off from the contracting civil sector by taxes, loans or such other means and poured into the expanding war sector The penalty for the inability to do it is the development of inflation

Now to know whether inflation has developed in India and if so, in what form, two enquiries have to be made It is necessary, on the one hand, to ascertain whether the expansion of currency has gone beyond the requirements of economic activity or has merely been evoked by the latter and, on the other, to find out if the government has been pursuing a lenient or wrong budgetary policy in not denuding the civil sector of economy of the surplus purchasing power flowing into it The first enquiry leads to an examination of the relation between currency expansion and wartime production, trade and employment and the second to an analysis of the methods and policy of war finance

Inflation in the sense of an inflationary issue of currency can be said to exist in India only if the expansion of currency has outpaced the demand for it for sustaining economic activity at a higher wartime level It is well known that in 1939 when war broke out, Indian economy was still suffering from the after effects of the Great Depression of 1929-33 There were not only large reserves of man power in an idle or semi-idle state which could be put to work but there was also very considerable margin for stepping up both agricultural and industrial production Great hopes were aroused, therefore, when the war broke out of the inauguration of a new era of economic prosperity characterised by an all round economic development But it was not long before the collapse of France and its sequel in May-June 1940 damped

those hopes by causing a big loss of markets for Indian agricultural produce on the European continent and depressing prices in India[1] It was not until October 1940 that the psychological effects of this setback wore out and fresh advance in production and prices was resumed After this period, Indian economy was subjected to two opposite sets of forces, one tending to stimulate its expansion and the other to hamper it The first set included such factors as bountiful harvests, the increasing tempo of war, the steadily growing volume of war orders to Indian industry, heavier internal demand due to increasing money incomes coupled with the curtailment of imports, and lastly, the gradual transformation of India into a vital supply base for the Allied forces in the Middle and Far East The second set comprised such factors as the growing strain on the available shipping space and the consequent difficulty of sending out exports and obtaining some vital imports, in particular the difficulty of getting machinery and machine tools, curtailment of road transport due to petrol shortage and heavy pressure on rail transport, and, above all, the lack of clear insight on the part of the framers of economic policy into the nature and magnitude of forces at work and also of the lack of foresight and perhaps also of the will to draw up and execute with public co-operation a comprehensive and co-ordinated plan to deal with them The net effect of all these forces at work has been an expansion of economic activity which falls far short of both the needs of the country and of the opportunities opened up by the war Statistics of agricultural and industrial production available at present (and set out in the form of indices in the three tables below) do not support any estimate of more than 20 per cent increase on the average in India's production during the war

[1] The total value of the exports for which markets were lost was estimated at the pre-war level of prices at Rs 29 crores (*Report by T E Gregory and Sir David Meek* 1940 p 14)

Indices of agricultural production

	1938-39	1939-40	1940-41	1941-42	1942-43
Rice	100	107 6	92 4	105 8	102 4
Wheat	100	108 2	100 4	101 1	110 1
Cotton	100	71 2	83 4	88 3	65 6
Jute	100	143·0	193 3	80 3	132·2
Sugarcane	100	137 6	171 1	129 1	168 1
Groundnut	100	98 3	115 0	80 3	84 3
Linseed	100	105 7	97 3	81 7	93 0
Castor seed	100	87 4	94 6	82 0	132 4
Sesamum	100	104 8	106 6	104 5	113 9
Rape and mustard	100	118 9	117 3	118 0	113 0
*General average**	100	108 3	117 1	97 1	111·5

Indices of Industrial Production[1]

Commodity	1938-39	1939-40	1940-41	1941-42
Pig iron	100	116 6	125 6(c)	130·3(c)
Steel ingots	100	109 5	122 8(c)	138·7(c)
Finished steel	100	115 7	137 7(c)	150 7(c)
Cotton twist and yarn	100	94 8	103 5	121 0
Cotton piecegoods	100	94 0	100 0	105 2
Sugar	100	182 1	149 5(c)	119 2(c)
Paper	100	119 6	148 1	152·9
Matches	100	104·3	109 8	78 4
General Average*	100	117 1	127 6	124 5

* Simple Arithmetical (c) Estimated

* Simple arithmetic average

[1] Figures of production for 1942 43 not being available for a number of industries index for 1942-43 has not been given but as production declined in several industries such as paper cotton textile etc, the index for 1942-43 would be very likely lower than that for 1941-42

"*Capital*" *Index of Industrial Activity*[1]

Items	1938-39	1939-40	1940-41	1941-42	1942-43
Indian cotton consumption	100	94 9	106 5	124 8	128 2
Jute Manufactures	100	105 1	91 0	100 2†	96 7†
Steel ingots	100	109 6	122 7	138 7(*e*)	127 2(*e*)
Pig iron	100	117 0	125 6	130 3(*e*)	120 2(*e*)
Paper	100	118 1	146 7	154 4†	123 0†
Coal	100	101 1	104 8	98 1(*e*)	96 5(*e*)
Rail and river borne trade	100	105 7	102 3	100 7†	88 7†
Cheque clearances	100	99 3	89 1	91 8†	69 0†
General Index	100	102 6	105 6	110 4†	97 9†

† Provisional (*e*) Estimated

Some more data, which unfortunately are not available, particularly of employment and internal trade are necessary for correlating expansion of currency with economic activity[2] But even with such data of production and prices as are available it is hard to escape the conclusion that the supply of currency has far outrun the demand for it

It is, of course, difficult to trace the relationship between supply and demand during the last four years and to say exactly when currency expansion took the lead and upset the balance between the two The general level of prices the rise in which has been chosen as the most obvious manifestation of inflation was by no means in the normal or optimum state at the outbreak of war The initial rise in agricultural prices after the war was indeed welcomed as a well deserved recompense to the agriculturist for the hard days he had known By the end of the second year of war, note circulation had gone up by a little more than 50 per cent and prices by a little less than 50 per cent Considering that the velocity of circulation of money had declined somewhat and a number of factors such as higher charges of labour, raw material and transport were tending to raise cost of production and prices

[1] Based on the table in *Capital*, December 2nd, 1943

[2] It has been pointed out by Mr G D Birla that the volume of transactions which are done in cash has increased a good deal during the war Moreover the number of stages through which commodities have to pass has also increased under the wartime system of selling and buying (*Cf* his *Inflation and Scarcity*, p 13) This would mean that the economic activity *for which currency was required* had greatly expanded

and considering also that the rise in prices represented to some extent a much needed measure of reflation or 'pump-priming', the situation at the beginning of the third year of war could not be pronounced to be very perturbing. Note circulation and prices, however, were being pushed forward by the dynamic urge of war expenditure. In the third and fourth years of war currency expansion went forward at a breath-taking pace causing a veritable price flurry Every addition to currency now represented a fresh draft on the real resources, and, owing to the resulting rise in prices, each successive dose of currency had to be followed by a larger one to 'rake off' the same amount of real resources As more and more real resources were absorbed for the prosecution of war without corresponding additions being made to them, the already low standards of living were undermined further and by the middle of 1943, food and cloth—the two vital necessaries of life—became so scarce as to be almost unobtainable for the vast majority of people Deaths by ghastly starvation occurred in the streets of Calcutta in August 1943 and in despair it was asked (by inverting Adam Smith's well-known dictum) if defence was after all better than indigence Clearly, a big inflationary issue of currency had been under way piling up heavy burdens

This inflationary issue might not have led to the development of, what has been termed earlier, an inflationary situation if strong measures had been taken from the very beginning to bring the volume of purchasing power in the war sector and civil sector of economy into some correspondence with the respective amounts of real resources in the two sectors While the remedy for the inflationary issue was an expansion of the volume of goods and services offered against money, the prophylactic against the onset of an inflationary situation was a sound system of war finance The effects of the inflationary note issue could be mitigated by expanding production, given the inflationary issue, no matter how caused, the situation could be retrieved by drawing off the purchasing power running in an ever swelling stream into the civil sector and pressing on the limited supplies of real resources But the economic policy of the Government has

not brought about the former and their peculiar system of war finance has failed so far to achieve the latter. A discussion of the Government's policy relating to production, involving as it does an examination of their attitude towards Indian industry and of their measures for increasing food supply, will stray into many fields that have no direct relation to currency[1] But an expatiatory treatment of the system of war finance which is really the *fons et origo* of both inflationary issue and inflationary situation, is both necessary and relevant

War Finance—magnitude and methods

The amount of defence expenditure that India has to bear is governed by the provisions of the Financial Agreement reached between the British Government and the Government of India shortly after the outbreak of war and brought into force with retrospective effect from 1st April 1939 By the terms of this Agreement the British Government is to implement the programme laid down by the Chatfield Committee for the modernization of Indian army and involving a capital outlay of Rs 46 crores[2] The expenditure on defence measures undertaken by India and debitable to Indian revenues has been reduced to a formula and it consists of the following items .—

(*i*) a fixed annual sum representing the normal net effective costs of the army in India under peace conditions, fixed at Rs 36'77 crores

(*ii*) an addition to allow for rise in prices.

(*iii*) the cost of such war measures as are undertaken by India in her own interest such as mobilisation of Indian Territorial Force and Auxiliary Forces, measures of port and naval defence etc., and

(*iv*) a lump sum payment of one crore of rupees towards

[1] For a short critique of the Government's industrial policy during the war, refer to my *Review of Indian Fiscal Policy*, Section VI

[2] The Chatfield Committee was appointed with Lord Chatfield as chairman shortly before the war to go into the whole question of modernization of Indian army and its recommendations had been accepted by both the British Government and the Government of India

the extra cost of maintaining India's External Defence Troops overseas

To these items of expenditure may be added the non-effective charges, the amount of which varies somewhat from year to year but which must increase as the war progresses The liability of India for surplus war stores will be determined by negotiation at the end of war

Any expenditure in addition to the sumtotal of these five tems, though it may be immediately borne by India, will be eventually recovered from the British Government

Proposals for revising the basis of the allocation of defence expenditure between the two countries were made by the British Government towards the middle of 1942 but the Government of India successfully resisted them The original agreement, therefore, stands, though a new interpretation of some of its provisions has led to larger expenditure being debited to India's account

The defence expenditure of India was bound to record an increase with the extension of the scale and the acceleration of the intensity of hostilities but the extent to which the increasing tempo of the war has upset the estimates of the Finance Member of the Government of India was somewhat unexpected Upto March 1940, the *increase* in expenditure attributable to the war did not exceed Rs 4 crores and the improvement in revenue more than covered it For 1940-41, the total defence expenditure was estimated at a figure of Rs 53 5 crores in March 1943, a little over Rs 68 crores in November 1940 and at a little over Rs 72 crores in March 1941 For 1941-42, the defence expenditure was estimated at Rs 84 crores in March 1941 but the revised estimate one year later exceeded this figure by more than 18 crores For 1942-43, the expenditure was estimated at Rs 133 crores but the revised estimate in February 1943 yielded a figure of Rs 189 crores excluding capital charges or over Rs 239 crores (or about 65 lakhs per day) after including the capital charges For 1943-44, the current year, defence expenditure including the capital charges has been estimated at over Rs 199 crores and excluding the capital portion at Rs 183 crores, thus envisaging for the first time since the war began a decrease

in defence budget. But with a heavy onslaught on Japan in the Far East in the offing, these figures may well turn out to be a gross underestimate

To this purely defence expenditure must be added the civil expenditure, both central and provincial, directly attributable to war in order to know the total outlay on defence measures debited to revenue The following table give the total expenditure on defence measures from April 1939 to March 1944 —

	in crores of rupees
Central defence expenditure (including expenditure on capital account)	665'63
Central civil expenditure directly attributable to war	37 80*
Provincial expenditure directly attributable to war	27'93*

By far the most important item in the expenditure arising out of the war which is not included in the central budget but without which no computation of the money cost of war to India would be complete is the expenditure incurred in India on behalf of British and other Allied Governments No figures about this expenditure are being furnished by the Government but some measure of it can be obtained from the total sterling payments made on this account by the British Government which amounted for the war period upto 31st March 1943 to Rs 571 crores.[1] War expenditure recoverable from the British Government has been estimated at Rs 346 crores for 1943-44 and may be placed for the whole of the war period upto March 1944 at over 1000 crores of rupees

Thus a total amount of about 1700-1800 crores of rupees exclusive of the extra expenditure of Provincial Governments represents the total *direct* money cost to India *during* the war period upto March 1944 Of this, Rs 1500 crores may be taken as the direct financial burden of the war.

* These figures are for the increase in total central and provincial civil expenditure during the war and are found by deducting from the estimated total expenditure for 1943-44 the expenditure in 1938-39

[1] *Report on Currency and Finance, 1942-43*, p 25

Period	Tax	Levied for the first time or increased	Rate
1942-43	Income-tax	increased	Exemption limit lowered to Rs 1 500
	Corporation tax	increased	To 1½ as in th rupee
	Surcharge on income-tax and super-tax	increased	From 33⅓ to roughly 50 per cent
	Emergency surcharge on import duties (raw cotton salt and motor spirit exempted)	levied	20 per cent
	Excise duty and import duty on motor spirit	increased	To 15 as per gallon
	Excise duties on kerosene and silver	increased	To 3 as 7½ p. per oz (silver) To 0-3-9 per imperial gallon
	Postal letter rate	increased	From 1¼ to 1½ as
	Rates for telegrams	increased	From -/10/- to -/12/- for ordinary and Re 1-4-0 to Re 1-8-0 for express
	Surcharge on trunk telephone calls	increased	From 10 to 20 per cent
	Telephone rentals	increased	By 16⅔ per cent
1943-44	Income-tax—surcharge and supertax	increased	On incomes above Rs 5,000
	Excise duty on tobacco produced and manufactured in India	levied	Ranging between 1a and Rs 1-12 per lb for unmanufactured and 2as and Rs 6 for manufactured
	Excise duty on *Vanaspati*	levied	Rs 5 per cwt
	Postal and telephone rental rates	increased	Letter rate to 1a for each tola after the first Parcel rate to 6as for first 40 tolas Telephone surcharge from ⅙ to ⅕

The total taxation revenue from 1939-40 to the end of March 1944 has been reckoned at Rs 534 crores of which direct taxes account for Rs 232 crores and the main indirect taxes at Rs 302 crores[1]

There are two other measures that have been adopted since the outbreak of war to strengthen the revenue position of the Government Firstly, the Distribution of Revenues Order, 1936 (embodying the Niemeyer Award) has been amended to provide that during 1939-40, 1940-41 and 1941-42, the Central Government would retain out of the distributable 50 per cent of the income-tax proceeds an amount of Rs $4\frac{1}{2}$ crores[2] Secondly, the railway fares and freights have been raised and the moratorium on the payment of the arrears of railway contribution to general revenues continued till 1941-42 so that a larger contribution from the railway revenues to general revenues has been rendered possible In 1942 all the arrears of railway contribution were paid off and, therefore, in 1943, interim wartime changes in the Railway Convention of 1924 were adopted so as to permit a substantial contribution by the railways in consonance with the war needs of general revenues The railway contribution to general revenues during the war years has been as follows .—

	(In crores of rupees)
1939-40	4 33
1940-41	12 16
1941-42	20 17
1942-43 (R E)	20 13
1943-44 (B E)	27 10
Total	83 89

(*b*) *Borrowing* The borrowing programme of the Government, described as the Indian Defence Savings Move-

[1] *Explanatory Memorandum to the Budget for 1943-44*, p 25

[2] This provision was extended to the year 1942-43 in terms of the direction of Governor General issued on the 7th April 1943

ment, was put into effect from June 4, 1940 and to begin with comprised Three-year Interest-free Defence Bonds, 3% Six year Defence Bonds and Ten-year Defence Savings Certificates The Six-year Defence Bonds were issued in two series, the first with effect from the 10th June and the second to which conversion from 5% 1940-43 Loan was allowed, from the 1st August, 1940 The sale of these Bonds was discontinued from the 25th January 1941 and their place taken by 3% Second Defence Loan 1949-52 issued with effect from 1st February From 1st April 1941, a new scheme of Post Office Savings Bank Accounts to facilitate popular savings was brought into operation The amounts in these Accounts are repayable not on demand but one year after the end of war, the rate of interest carried by them being 2 1/2 per cent *i.e.*, one per cent higher than the existing rates on Savings Bank Accounts On the 14th February 1942, the 3 per cent Second Defence Loan was closed and on the 4th July 1942, the 3 per cent Third Defence Loan was issued in the form of a reissue of an earlier Loan first issued in 1935 On the 1st October 1942, a special issue of 3 per cent Loan 1963-65 was made in connection with the arrangement made for the funding of sterling obligations in respect of railway annuities Subscriptions to the Third Defence Loan were closed from 1st July 1943 and a Fourth Defence Loan was issued in its place From 1st October 1943, it was decided to close the issue of Ten-year Defence Savings Certificates and to substitute for them a new attractive scheme of Twelve-year National Savings Certificates The rate of interest allowed on Post Office Savings Bank accounts was also raised from the same date On 22nd October, the 3 per cent Funding Loan 1966-68 of Rs 25 crores was floated and in January 1944 a special issue of Rs 50 crores of this loan was created

Among the other items in the borrowing programme, the most important is the sale of the rupee counterparts of those sterling loans which were repatriated under the voluntary and compulsory repatriation schemes [1]

The total amount subscribed to all Defence Bonds and

[1] *Vide* §6

Loans, the Defence Savings Certificates and Defence Savings Bank Account was upto the 31st March, 1943 Rs. 301 5 crores, being composed as follows[1] —

	(In crores of rupees)
Interest-Free Defence Bonds	3 06
Three Percent Defence Bonds	
(1) First Series	71
(2) Second Series	44·43
Three Percent Second Defence Loan	59 1-
	(in crores of rupees)
Defence Savings Certificates	7·23
Defence Savings Bank	40
Three Percent Loan 1951-54	40 27
Rupee counterparts (net investments)	131 24
Three Percent Loan 1963-65	15 00
Total	301 50

In addition to this long-term borrowing, the Government of India have also increased their short-term borrowing in the form of Treasury Bills and Ways and Means Advances from the Reserve Bank of India The total amount of outstanding Treasury Bills and Ways and Means Advances increased from Rs 46·3 crores at the end of 1938-39 to Rs 264 7 crores at the end of 1942-43, *i e*, there was a net increase of Rs 218 4 crores To a substantial extent, the Treasury Bills have been merely substituted for the sterling securities in the assets of the Reserve Bank's Issue Department and there has been no additional issue of currency against them [2]

The rupee debt of the Government has on account of the borrowing and sterling repatriation operations increased during the war by nearly Rs 600 crores (up to the end of 1942-43) and the sterling debt was reduced by about Rs 370

[1] *Report on Currency and Finance*, 1942-43 p 44

[2] This was pointed out by the Finance Member during the course of his Budget speech (February, 1943) probably in reply to Prof Vakil's statement in his *The Falling Rupee* to the effect that the Government was obtaining rupee finance by means of Treasury Bills and thus engineering 'inflation in its naked form', Vakil's well-reasoned rejoinder, in the first issue of the *Eastern Economist* (dated 22nd May, 1943), does not seem be very convincing on this point.

crores, showing a net addition of Rs 230 crores to India's total public debt. The rate of interest paid on the loans raised by the Government has been kept low—at about 3 per cent—due to the successful maintenance of cheap money conditions during the war.

Saving Schemes. In their borrowing programme, the Government have not placed much direct reliance on saving schemes, though a few of them have been brought into operation as auxiliaries of taxation or control measures Three schemes, two of them voluntary in character, were introduced along with the changes made in 1942-43 in the rates of income-tax, surcharge on income-tax and excess profits tax Under the first scheme, income-tax leviable on incomes between Rs. 1,000 and Rs. 2,000 on the excess over the first Rs 750 of total income will not be levied if the assessee exercises the option of depositing a prescribed sum in a Savings Bank Account The prescribed amount is one rupee for every 25 rupees by which the total income exceeds Rs. 750 and is, therefore, approximately 1.1/4 times the amount of tax to which the assessee would otherwise be liable. Under the second scheme, which is compulsory in effect, the incidence of the newly introduced rates of surcharge on incomes not exceeding Rs. 6,000, is mitigated by funding 1/2 per cent of the assessee's total income for his benefit and providing for its repayment to him after the war. Under the third scheme, the Government would contribute an amount *upto* 10 per cent of the net excess profits tax (the rate of which stood at 66 2/3 per cent) provided the assessee deposited a sum equal to double this amount. The contribution placed in reserve by the assessee would be repayable within 12 months of the end of war while the contribution made by the Government would be paid out at such time and subject to such conditions as might be determined This scheme, optional in character upto 17th May, 1943, was converted into a compulsory scheme by an Ordinance of that date Now a deposit at the rate of 20 per cent of the excess profits tax, *i e*, 13.1/3 per cent of excess profits has been made compulsory for all assessees, the Government making their contribution a the rate of 6.2/3 per cent.

Lease-Lend aid India has been receiving goods and services from U S A under the Lease-Lend arrangements and the value of these was estimated at $300 or about Rs 100 crores upto the end of 1942-43. Lease-Lend aid is in the nature of foreign borrowing though it is not clear in what form the liability of the récipient of this aid will be discharged at the end of the war Lease-Lend represents an innovation in the sphere of international finance during the present war A direct agreement between India and U. S A concerning Lease-Lend has not yet been concluded but India is incurring some expenditure on U S troops stationed in India—Reciprocal Lease-Lend aid, as it is called—which was estimated to amount in 1942-43 and 1943-44 to Rs 16 70 crores and Rs 8 04 crores respectively[1]

(c) *Inflation* As was pointed out earlier, taxes and borrowing have not been adequate to cover the total expenditure incurred by the Government of India in connection with defence measures The Government have no doubt been able by these means to balance their budget but they have *not* been able to draw to themselves sufficient purchasing power to balance their budget *as well as* meet the expenditure incurred by them on behalf of the British and Allied Governments The question which naturally arises and which forms the core of inflation issue is how has this expenditure been met?

The question admits in a way of the simple answer that the British and other Allied Governments have been making payments to the Government of India in sterling and the Government of India have been releasing the equivalent amount of rupees for the expenditure incurred by or on behalf of these Governments Further details worth mentioning about this process are that sterling accumulates in London with the Reserve Bank of India and is invested in sterling securities which are then lodged in the Issue Department of the Bank and form the backing behind the notes issued in India[2] The table on the next page brings out the

[1] *Budget Speech*, 1943-44 para 26

[2] For an illuminating account of the whole process, *vide* Sir C D Deshmukh s Rotary Address (*Commerce*, 5th Sep, 1943)

(*In crores of rupees*)[1]

Year	Month	Total Note issue	Notes in Circulation	Gold Coin and Bullion	Sterling Securities	Rupee Coin	Rupee Securities
1939	Aug	216 8	178 9	44 4	59 5	75 5	37 4
	Sept	221 4	202 9	44 4	64 5	75 1	37 4
1940	Feb	254 6	239 6	44 4	113 5	58 3	38 3
	May	257 0	248 5	44 4	123 5	46 6	42 5
	Oct	257 2	228 7	44 4	131 5	31 6	49 6
1941	Jan	260 5	245 0	44 4	135 5	31 0	49 6
	Aug	293 0	276 6	44 4	131 6	38 5	78 5
1942	Jan	366 2	356 4	44 4	248·6	31 6	41 5
	Aug	487 3	474 3	44 4	311 8	28 7	102 4
1943	Jan	604 2	593 3	44 4	355 8	14 6	189 4
	Aug	766 3	754 6	44 4	618 8	14 7	88 4
1944	Jan	862 9	853 7	44 4	744 8	15 3	58 3

[1] Figures after June, 1942 exclude Burma. Figures for rupee coin include one-rupee notes after July 1940

increasing extent to which sterling securities have supported the note issue during the war

In normal times any accumulated sterling in England could have been utilized for purchasing and importing tangible goods and services as well as gold but this procedure has not been found practicable for the duration of war. In effect, therefore, India has extended to Great Britain a huge commodity credit which will be repaid after the war The amount of credit has been obtained internally not so much by depriving those who have of the utmost they can give as by a process of nibbling at the paltry stocks and subsistence of those who have never risen very much above the poverty line The investment of sterling balances in British securities has made available large funds to the British Government who have to this extent been able to avoid resorting to credit inflation The release of corresponding amounts of rupees in India has swelled the volume of currency circulation It is thus that inflation has been kept at bay in England and unleashed in India The war has entered, as it were, a *minus* item of goods and a *plus* item of note issue in India's national balance-sheet and added, at the same time, a *plus* item of goods and a *minus* item of currency circulation in England's national balance-sheet

Some Aspects of Inflation

Inflation and sterling balances The relation between sterling balances and inflation may be viewed from three angles firstly, the precise connection between sterling accumulation and currency expansion, secondly, the extent to which the presence of large sterling assets and the possibility of their conversion into tangible goods in future may be considered an inflation-damping factor, and thirdly, whether in spite of the presence of these assets, Indian currency may be described as 'fiat money'

As regards the first, it is clear that sterling must accumulate with the Reserve Bank so long as the British and Allied governments make purchases in India and pay for them in sterling But it is not inevitable that internal expansion

of currency should result from the accumulation of sterling If, for example, the whole of the purchases in India can be made by rupees obtained from Indian people themselves by taxes or loans, no additional currency need be issued at a against sterling accumulating in England. It is because the Government of India cannot get hold of sufficient rupees to make all the payments that they are called upon to make, by the normal means that they have recourse to the Reserve Bank machinery for obtaining rupee currency against sterling Again, it is open to the Government of India, even if they were not receiving sterling, to secure additional rupee currency by the simple expedient of borrowing from the Reserve Bank against its own securities "Thus there is no natural or necessary relation between the growth of foreign assets and internal expansion or monetary inflation and the link between the two phenomena is optional Inflation may, and generally does, develop without any growth in foreign balances, and foreign balances may in theory grow without causing a corresponding degree of inflation "[1]

As regards the anti-inflationary effect of sterling balances, it is possible to exaggerate it Just as the mere accumulation of foreign balances need not give rise to inflation, the mere presence of such balances need not counteract it. For inflation arises basically from the disturbance of currency—economic activity ratio, though at a certain stage the lack of confidence in the currency may become an inflation—aggravating factor. The backing of sterling assets behind expanded currency may possibly strengthen the confidence factor and may to that extent damp inflation but then there must be unshaken public faith in the future value and availability of these assets

The Manifesto issued by the twenty Indian Economists in April, 1943 characterised the inflation in India as 'deficit-induced fiat money inflation' The description may be generally correct but is not explicit on two points In the first place, the deficit that has induced the inflation is not caused by a gap between the ordinary war-time expenditure

[1] Rotary address of Sir (then Mr) C D Deshmukh Governor of the Reserve Bank, 31st August, 1943

and revenue of the Government of India, but by the *extra-ordinary* expenditure which it has been called upon to meet Secondly, the notes going into circulation can be described as fiat money only if the sterling securities against which they are issued are treated as worthless assets incapable of being converted later on into tangible goods and gold As a natter of fact, it is hard to find an exact precedent for the ndian inflation, and, therefore, difficult to classify it It is nflation *sui generis* and may be treated as such.

Inflation and Velocity of Currency Circulation It would be difficult to deny that the fall in the velocity of circulation has acted during the war period to some extent as an inflation-damping factor It is, however, difficult to assess its present magnitude or predict its future course Figures of velocity of circulation have a limited utility as indices in so far as a large volume of payments during war time is made in cash This must be so more particularly when black markets are rampant and when the small incomes of those who keep no bank account increase [1] But the broad trend suggested by the figures can hardly be doubted, though it would in no way lull disquietude for the future For lower velocity of circulation represents a reserve of immobilised purchasing power which, whenever it comes into operation, will be a factor of serious magnitude

Inflation and Social Justice Inflation as a means of meeting the cost of war achieves no doubt the same objective as the two other methods of taxation and borrowing but it does so by effecting the most arbitrary and inequitable changes in the economic position of different classes and persons and by introducing into the *economic system* the germs of distemper [2] The lessons of the havoc worked by inflation in the post-war years of 1919-23 had been learnt so well by thoughtful men that when this war broke out, clearest warnings were sounded in belligerent countries like England against letting

[1] B C Ghose, *The War and the Rupee* pp 3-4

[2] *Cf* An endless period of rising prices destroys two very important social things, it destroys the value of saving and it destroys the worker's standard of living " (Gregory *Current Problems of International Finance*, 1930)

the spectre of inflation raise its ugly head.[1] The close bearing of the methods of war finance on the social distribution of wealth also received firm emphasis The 'deferred pay' scheme put forward by the eminent economist, Lord (then Mr.) J. M. Keynes, for England soon after the war aimed at greater social justice no less than at efficient finance of war[2] In India, however, there does not seem to have been sufficient appreciation of the social and distributional implications of war finance The burdens imposed by the war (and the gains accruing from it) cannot be claimed to have been equitably distributed among the different sections of population There are some groups who have been able to secure most of the gains and escape many of the burdens, these include, broadly speaking, the bigger landlords, war contractors, profiteers and speculators There are others who have not borne their proper share of the burden and these cover all persons with large incomes including industrialists, bigger traders and highly skilled personnel in war empolyment Then there are also groups about whom it cannot be said that their gains in the form of fresh or more lucrative employment have not been outweighed by heavier burdens imposed by scarcity, high prices etc, these include small landholders, tenants, small artisans and traders, domestic servants and the organized industrial workers[3] And finally, there are persons having more or less fixed incomes and low-paid workers, such as the

[1] In England, the financial control has been very effective, for while the total Central Government expenditure has risen from £3 339 million in 1940 to £5,103 million in 1942 the proportion of it covered by ordinary revenue has risen from 38 per cent to 51 per cent A little less than half the expenditure is covered by savings of which small savings form a considerable part The extent of inflationary finance is extremely small (*Economic Journal* Dec 1941 and Sept 1943)

[2] Summing up the advantages of the scheme the central feature of which was the proposal for compulsory savings, Keynes observed 'It retains a stronger incentive to effort gives less sense of sacrifice and indeed requires less and spreads through the community the advantages of security which saved resources afford, far more widely than before' (*How to pay for the war* 1940, p 44)

[3] One gain generally recognised to have accrued to landowners in some parts of the country is the reduction or the complete repayment of past debts

salaried employees in Government or private employment, professional men, unorganised industrial workers, pensioners and agricultural labourers who have been called upon to bear a disproportionately heavy share of the burden Broadly and roughly, it may be said that the proportion of the country's real wealth which falls to the share of the low paid manual worker, the fixed income black-coat employee and the small producer has been diminishing while the proportion commanded by the big supplier and middleman, the war profiteer and speculator, the large investor and producer has been increasing [1]

It may also be pointed out that Indian people, as a whole, with their low average income per head have been called upon to bear under the present financial arrangements an unbearably heavy burden The burden is felt to be particularly intolerable because the present generation is being called upon to bear almost the whole of it The gains from extinction of past debts and growth of sterling balances open promising vistas for the future generation but provide little relief to the present

Inflation and the Agriculturist The severe criticism levelled by Indian economists against inflationary expansion of currency and the consequent rise in prices has been treated with scepticism by some representatives of agricultural interests It has been pointed out that the rise in prices has opened the sluices of prosperity for the agriculturist which may not be closed by committing the error of deflation It is necessary so examine the point with special reference to the Punjab which is generally considered to enjoy a higher degree of agricultural prosperity than many other Provinces The agriculturists in India form such a vast mass that it would be foolish to try to cover them by a single general statement There are some nine groups into which those connected with agriculture may be divided the bigger, the middle and the smaller landowners, tenants, landless labourers, artisans, menials, traders and money-lenders The line of division

[1] For the general effects of the rise in prices during the last war, see *Babington Smith Committee's Report*, para 47

between the bigger, the middle and the smaller landowner, the smaller owner and the tenant, and the tenant and the landless labourer cannot be drawn very sharply. In the Punjab, the smaller, the middle and the bigger landowners would be those who own 3—15, 15—50 and above 50 acres respectively, those owning less than 2—3 acres would approximate in material status to smaller tenants[1]

No data are available as to how the nine groups have been affected by inflation and it is, therefore, impossible to measure improvement or deterioration in standard of living in quantitative terms, but some *ad hoc* enquiries regarding war-time changes in rural life would suggest some broad conclusions The bigger landowner, by all accounts, has gained on balance, *i e*, even after allowing for the rise in the prices of goods such as cloth etc, which he consumes He has purchased more land or house-property wherever he could or made investments in gold or accumulated cash. He has cleared off or considerably reduced his debts and redeemed mortgages In real terms his position is much better than before the war The middle landowner has also improved his material condition by reducing debt, redeeming mortgage, purchasing land or accumulating some cash, though not to the same extent as the bigger landowner. The smaller landowner (who may at the same time be a tenant) who is little more than a subsistence farmer has both gained and lost and it is difficult to strike the balance. Whenever he had a surplus to sell, his money income has gone up and he has utilized it to pay off his old debts[2] He has also been able to pay up the government demand by parting with a smaller amount of his produce and to that extent has been enabled to retain and/or consume more The supplementary occupations pursued by him have also fetched more and when a

[1] The percentage of the bigger, the middle and the smaller owners in the Punjab is roughly 2 5, 10 and 38 The proportion of those holding below 3 acres is about 50 per cent. As regards area held, the corresponding figures for the four classes are roughly 38 0, 28 0, 28 0 and 6 0 respectively

[2] *It may be mentioned here that agrarian legislation of 1934-39 had already enabled him to wipe off a part of his debt*

member or two of a family have joined the army, a small stream of money has flowed into the family from that direction The rise in the value of land has been utilized in some cases to sell a part of the holding to redeem the mortgage over another and a larger part Against these, one must place, first of all, the higher prices of goods that enter into the cost of cultivation—livestock, wood and iron for the plough and the sinking of a well The prices of articles of consumption—cloth, kerosene, matches etc ,—have gone up, though it would be wrong to think that they have affected the agriculturist to the full extent of their rise because of his capacity to limit his wants or use substitute (village made) articles of inferior quality Transport—both by road and rail—has become more costly and the price of gold and silver which were used both for personal adornment and investment has increased On the whole, it cannot be said that the small landowner has made any definite real gain during the war, though he has been able to extricate himself from a substantial part of his past encumberances As regards tenants, the cash contract tenant would gain when prices are rising but in the Punjab about 75 per cent of the area under tenancy is held by batai tenants (or share croppers) Moreover the cash rents have risen along with a rise in prices As for the share-cropper, his position is in many respects similar to that of the small landowner, though it is weaker and less satisfactory

The landless agricultural labourer has suffered heavily in some parts of the country such as Bengal on account of starvation as well as scarcity of cloth He forms the submerged section of rural population and the tendency reported from some parts of the country for kind wages to be replaced by cash wages has exposed him more than before to hunger and want In the Punjab, however, he does not seem to be worse off because the greater demand for his services in a period of labour shortage caused by recruitment to the army has led to a rise in wages almost proportionate to the prices The rural artisan and the menial obtain a customary share of the crop from the threshing floor and there appear to be no signs of the custom giving way (not at any rate in the Punjab) in the conditions created by the war Moreover, it is to this

group that the war has opened up several opportunities of employment—alternative or additional—in the army or outside. Had it not been for these opportunities, he would have fared perhaps only a little better than the landless labourer but not very much better than before the war The village money-lender has suffered both on account of the agrarian legislation and the war and has been drifting to the cities.[1] The village trader (where he was not a moneylender) has suffered a small loss through scarcity of supplies of goods he used to sell and a smaller turnover of foodgrains due to hoarding or direct sales to the buyer but he has largely or wholly made it up either through higher prices or through a larger quantity of foodgrains handled (because of larger production).

It would, thus, appear that the larger landowner and to a smaller extent the middle landowner has definitely gained and the village moneylender definitely lost. The other groups have gained slightly in some directions and lost in others.

From the long range point of view, inflation is an ill wind that blow no agriculturist any good *Some* rise in prices was bound to benefit him and was in fact very much his due after a protracted depression but a large continuous inflationary rise heightens the certainty of an eventual, sudden and steep-downward reversal Altogether, therefore, the agriculturists at large should have very little cause, to hail inflation with any genuine satisfaction

Progress of Thought about Inflation Timely and effective measures to deal with these and other consequences of war finance in India might have been undertaken if there had been clearer understanding of the character and gravity of what was happening In place of them there was a series of illconceived, irresolute and sporadic measures emanating from the varied and conflicting views and opinions jostling one and another for mastery in the general *mêlee*.

Even as late as July 1942, the Central Board of Directors of the Reserve Bank said in their Annual Report presented to

[1] The situation is somewhat analogous to that in the United States, in the later years of the American Revolution when creditors were found 'running away from their debtors, and the debtors pursuing them in triumph and paying them without mercy'

the shareholders that "although most of the recognised elements of inflation are present, there is no evidence that inflation is present in the country in any serious form". There was, furthermore, a reluctance to recognise that the sequence of cause and effect ran from currency expansion to rise in prices [1] But the magnitude and rate of fresh additions to currency were growing so heavy and the rise in prices so mercurial that it became difficult to deny that a condition of fairly serious inflation was developing in the country. In January 1943, Professor D N Vakil crystallized the floating mass of views and partial analyses of the seriousness of inflation in India into a compact and clear analysis, in his *The Falling Rupee* Denials that there was inflation in the country did come, however, supported with plausible arguments from even some of the best informed persons The Finance Member of the Government of India in the course of his speech introducing the Budget in March, 1943 made a number of important observations on the inflation problem in India [2] The most important among these were (1) that currency expansion was due to larger cash payments arising from the intensification of Government's war activities and also the increased demand for cash from the public (2) that there was no credit inflation in India but only a "temporary situation in which an increase in the volume of purchasing power impinges for a time on a stationary or diminishing volume of consumable goods" and (3) that if war results in victory for the United Nations and therefore, the British and Indian Government can pursue sound financial policies, "there is not the remotest risk of inflation of the nature and on the scale which occurred in some of the countries which suffered utter defeat in the last war" A few weeks later Mr G D Birla, a prominent businessman and industrialist, circulated a pamphlet entitled 'Inflation or Scarcity?' wherein he categorically denied the existence of inflation in India and attributed the rise in prices to the scarcity of commodities [3] On the 12th April, 1943, twenty

[1] Speech of the Governor of the Reserve Bank, August 1942

[2] *Budget Speech*, 1943-44 paras 50—55

[3] Apropos of Birla's views, the following remarks of Cannan relating

Indian economists issued a Manifesto which stated that the inflationary spiral was already at work in India and that the inflation was 'deficit-induced fiat money inflation' caused by the peculiar system of war-finance under which British and Allied purchases made in India were paid for in sterling assets against which currency was expanded in India The Manifesto affirmed the existence of a causal relation between expansion of currency and rise in prices and recommended a comprehensive series of measures for checking inflation and bringing prices under control[1] In May 1943, the Government of India in a resipiscent frame of mind appointed a Special Officer to report what deflationary measures were necessary to counteract the effects of the expansion of currency. The latest among the pronouncements on inflation is the observation made by the Central Board of Directors of the Reserve Bank in their Annual Report for 1942-43 that "inflationary tendencies steadily gathered strength encouraging and being in turn encouraged by scarcities of essential commodities including foodstuffs and cloth . Psychological factors superadded to the basic monetary and economic facts operated towards creating a highly unsatisfactory and unstable situation, although it is not possible with any degree of accuracy to assess the relative significance of the former. Nor is it possible to measure the relative contribution of rising money incomes and the growing scarcity of goods to the rise in prices "[2] No critical comment

to the last war are of interest 'During the war and afterwards when the currency began to depreciate it was often said, that the cause of the rise of prices was a growing scarcity of commodities This was supposed to be an argument in favour of increasing the currency, though it is difficult to see how any sane person could believe that the fact that commodities had declined in quantity was a reason for making that decline greater in proportion to currency by increasing the quantity of currency (*Money* p 103)

[1] Manifesto reproduced in Appendix B

need be offered on these opinions in view of the explanation of the character of inflation given earlier in this Section

Measures to Combat Inflation From this brief review of the financial operations of the Government and their consequences, there inevitably emerges the question if there was a more suitable alternative method in the past of conducting operations of public finance It may also be asked if some method can be substituted now for the existing one to deal with the situation that has already developed and to guard against its getting worse in future The more general form in which these questions are asked is how can inflation be checked at the root or in its effects?

Before passing on to the remedies for inflation, it is necessary to mention that the non-inclusion of disbursements made on behalf of the Allied Governments in Government of India's budget creates a wrong perspective for viewing the whole financial situation Even fresh taxation and borrowing may appear unnecessary when it is found that the Government's own budget is easily balanced It may be suggested, therefore, that if the incorporation into the annual budget of figures relating to the disbursements in India on behalf of the Allied Governments is not possible, the Government should prepare and present at the time of the budget a separate set of accounts showing the *total* disbursements and the *total* amounts raised by the Government of India and the inflationary gap

There can indeed be no single sovereign remedy for the evil of inflation, a number of measures will have to be combined to overcome its menace The measures that can possibly be taken fall under the following heads —

(i) Reduction in the volume of the Government's total disbursements (including those undertaken on behalf of other countries) to a point where the whole of them can be covered by non-inflationary methods of finance

(ii) Covering in full, without reducing, the Government's total disbursements (including those on behalf of other countries) by the non-inflationary methods of taxes, compulsory and voluntary loans, liquidation of foreign private investments in India etc

(iii) Refusal on the part of the Government of India to

furnish rupee finance to other Allied countries, *i e*, throwing on these countries the responsibility to raise the required finance themselves in the Indian market.

(*iv*) Adding to the reservoir of real resources by expanding production, stimulating imports, scaling down exports, importing and selling gold and forcing out hoarded stocks

(*v*) Preventing the incomes from getting inflated by the Government's disbursements, or from exercising pressure on the limited quantities of real resources, by instituting various controls such as control of investment, wages and profits, price control, rationing, control of speculation, etc.

Measures falling under the first head necessarily involve a contraction of India's war effort and will not appeal to those who would have India contribute an increasing share of her resources to the war effort of the Allies With the South Asian Command under Lord Mountebatten preparing a big offensive against Japan, they may even seem to be absolutely unthinkable The view taken by those who suggest such measures is that in the present economic and political set-up of the country, India's capacity to bear the burdens of war has been overstrained The task assigned to India is so heavy that already she has had to resort to concealed and indiscriminate taxation by inflationary methods in order to accomplish it So long as India's capacity to make her voluntary contribution to war is not considerably expanded by altering the whole political and economic set-up, there will be no escape for the Government from inflationary methods of finance From this it follows that in the present circumstances inflation can be checked at the root only by reducing the total amount of Government disbursements This is not so impracticable as it might appear, provided the Allied countries will come forward to shoulder all further burdens of the war Several issues, some of them political and military in character, arise from such a suggestion but it should be sufficient here to draw attention to the fact that before the war Indian economy rested on precarious margins and nothing very much by way of development has been done during the war to justify any great hopes of India's capacity to furnish the resources for war without pushing

large sections of population below the bare subsistence line

Measures coming under the second head do not at all concern themselves with India's capacity to bear the burden of war but seek to substitute for the inequitably distributed burden imposed by inflation, a more equitably distributed, and therefore, more bearable (though not less onerous) burden imposed by steeply graded taxes, compulsory and voluntary savings etc On principle there is nothing to be said against them, they are an efficacious antidote to inflation [1] Only under the present circumstances they may not always fulfil the expectations entertained of them Emphasis in this context may be laid on the fact that the large amount of purchasing power created during the war is not spread evenly over the whole mass of population but lies in a heavy deposit in some crevices and corners of the economy and in a thin veneer in others While, therefore, heavy pressure will have to be directly to some points, some withdrawal of pressure may be desirable at others The war contractors, bigger landlords and holders of highly paid war jobs at the one end and the newly employed, particularly the better paid, workers at the other may well be made to pay more either through heavier taxation or compulsory savings Saving schemes should be given a more prominent place in the borrowing programme which should indeed be shaped in such a way as to tap every little reservoir of genuine savings [2]

[1] There is even when non inflationary methods of war finance are being used a time lag between government disbursements and the inflow of income into government exchequer This lag might well create an inflationary gap but this would not be so wide as to be serious

[2] The 'save and lend' campaigns recently launched in some provinces like Madras and U P have succeeded beyond expectations and illustrate the possibilities of a well-planned savings drive That such a drive should be above all suspicion of undue or indiscriminate coercion need hardly be stressed Worthy of some attention in this context are the suggestions of S Srinivasan in his artice on *A Plan to Finane the War without Inflation* in the January 1943 issue of the Journal of the Indian Institute of Bankers It is, however necessary to point out that to make intensive drives for saving without at the same time taking direct measures to push down prices and ration consumption may for some time resemble nibbling at the consumer's cake from two ends, though it is recognised that increased saving (if it is genuine) is anti-inflationary

It has also been suggested that the Government should raise the rate of interest offered on loans to make them more attractive But raising the rate of interest at this stage is open to two serious objections first, it will adversely affect the value of gilt-edged securities with its inevitable reaction on banks and insurance companies and second, it will mark a reversal of the cheap money policy hitherto maintained and leave for the post-war period a structure of high interest rates[1] A good method of raising a few hundred crores of rupee finance would be to enforce a scheme for the liquidation of all the private foreign investments The process of liquidation will require the preparation of an inventory of different kinds of investments and the calculation of their value To some extent, the liquidation of these investments has been occurring spontaneously through change of hands under the scare of war conditions The process needs, however, to be hastened and intensified by judicious administrative pressure

Measures falling under the third head have been strongly urged in this country by some prominent economists[2] The suggestion has been made that the responsibility for finding rupee finance for the purchases made in India should rest on British Government who should, therefore, be asked to raise loans in India. In one important respect, such loans will be better than the accumulation of sterling balances in that they

[1] Besides, such a rise "will be a directly inflationary step which would inflate the whole structure of interest rates, raise the costs of industrial production and therefore industrial prices and increase the size of budget deficit' (*Cf* B K. Madan *This Inflation Problem Commerce*, January 1944) There are ways of making the borrowing programme of the Government attractive even without raising the rate of interest. A change in the whole psychological atmosphere in the country would be about the most efficacious way But short of it there are a few devices like the recent Prize Bond issue which may help to draw off some part of the purchasing power The issue which was announced in December, 1943, is a limited one, consisting of one lakh pieces each of Rs 10 and Rs 100 interest free bearer bonds repayable in 1949 Twice a year a lot will be drawn for each series of bonds for awarding prizes The issue introduces the principle of state lottery and is open to the objection that it panders to the less noble—the speculative and the gambling—instincts of men

[2] *Cf* C N Vakil *The Falling Rupee* 1943 and *Financial Burden of the War on India*, 1943

will be repayable in rupees and will, therefore, be free from the risks attendant upon depreciation of sterling But it is obvious that they can be successfully floated only if the atmosphere in India is favourable to their reception. It may also be noted that if the securities of the British Government against which people will lend are later used to secure credits from the banks, they may become the basis of credit inflation and thus defeat their own object From the standpoint of the yield of these loans also the suggestion is not very helpful, considering that the yield of even the Government of India loans has not been on the whole very encouraging It may perhaps be more straightforward to tell these countries not to depend on India for resources to the extent to which they are doing Reference may be made in this context to another suggestion sometimes put forward that it is the rupee-sterling link which has enabled the Allied countries to obtain rupee finance by the facile process of unlimited note issue and that the non-existence of this link at the outbreak of war or its rupture now will automatically shift the responsibility for finding rupee finance on to the shoulders of the Allied nations Coupled with this suggestion is another than a ceiling should be placed on the accumulation of sterling in the assets of the Reserve Bank of India How the rupee was linked to sterling in 1931 has been explained in an earlier chapter of this book [1] The manner in which it was done makes it clear beyond doubt that the rupee-sterling link is merely a symbol of economic and financial relations between India and England It should be as futile to tilt against the symbol as it would be think that if the rupee-sterling had not been there at the outbreak of war it could not have been established

Measures placed under the fourth head have a distinctive character in that they seek to combat inflation from the side of commodity supply rather than currency issue In respect of these, the record of achievement so far is rather disappointing With a more or less static, if not actually diminishing, production of food articles and industrial commodities and with the expanding require-

[1] See page 77

ments of the war, the sector of civil consumption has undergone severe contraction A strong, well-organised food production drive along the lines recommended by the Foodgrains Policy Committee and the grant of every possible facility to the Indian industry to import machinery, tools and technical advice can moderate the intensity of burdens imposed by inflation. These measures should be supplemented by a suitable trade policy, the anti-inflationary potentialities of which do not seem to have received the attention they merit By scaling down exports and stimulating imports, the reservoir of real tangible goods and services available within the country can be expanded Among the imports, both capital goods and consumers' goods are required but care will have to be taken that imports of only those consumers' goods are stimulated which will supplement and not supplant home production Import and sale of gold have been recommended both to withdraw currency from circulation and to coax the hoarders, particularly those in rural areas, to part with their stocks [1] Since the middle of 1943 the Reserve Bank of India has been selling in an intermittent manner small quantities of gold received from an undisclosed source but this does not seem to have had an appreciable anti-inflationary or anti-hoarding effect [2] Hoarding is an evil that must be dealt with directly by a rigorous control of prices, by tightening the machinery for procurement, by controlling the movement of stocks and by introducing rationing of essential articles of consumption The recent measures to force out hoarded stocks represent a move in the right direction It is, however, necessary to point out that their effects will wear out soon unless steps are taken to bring about an all round increase in production There is

[1] The suggestion for the import and sale in India of 30 million ounces (69 million tolas) of gold was made by Sir Chunilal B Mehta (*Cf* his letters to the *Times of India* Bombay dated 17th May and 3rd September 1943) In the second letter he suggested acquisition of gold from U S A under Lease-Lend arrangements

[2] Sir J Raisman in reply to a question in the Legislative Assembly on February 8, 1944 said that gold was provided by the British and American Governments from their own resources and the proceeds were utilized to meet the war expenditure of these governments But he was not prepared to disclose the amount of sales or the profits made

after all a difference between normal trade stocks and hoards and moreover, no country can live long on its hoards which are a fund and not a flow

Measures falling under the fifth head may to some extent check currency expansion at the source but mainly they are to be valued for their effect in forcing excess purchasing power to lie idle or flow into Government loans The various economic controls—price control, wage control, profit control, control of investment, control of speculation, control of private consumption through rationing—are designed mainly to prevent purchasing power from exerting its fullest pressure on the limited or dwindling quantity of consumers' goods The application of checks to the rise in prices, for instance, prevents the expansion of currency from going as far as it would otherwise go. A recent writer remarks with keen discernment, "we agree that given an inflationary fiscal policy, any procedure which keeps down the cost to the government of goods and services will correspondingly reduce the amount of monetary expansion which such a policy requires This is the element of truth in the doctrine that it is possible to check inflation by direct price control The better the bargains that the government is able to drive, the less the the pressure on the Treasury for the creation of more and more new money"[1] Price control in India has been hitherto unco-ordinated, ill-conceived and irresolute and needs to be screwed up as part of an anti-inflationary drive Wage control which is an essential adjunct of price control has not been attempted in India at all except that under the Ordinance of the 17th May, 1943, the funds set apart out of profits by way of bonuses and commissions can be regulated for income tax purposes Dearness allowances have been given by both government and private employers and, in so far as they were paid out of funds which would otherwise have remained idle or been invested in Government loans, must have had an inflationary effect[2] Yet it would as rash to question their desirability as it would be to exaggerate in comparison with other factors at work, their price-inflating

[1] Hardy *War-time Control of Prices*, 1940, pp 43 44

[2] Refer for further discussion of this question to Appendix C

activity On the other hand, the employment of many 'experts' by the governments at very high salaries, the creation of a number of war jobs and the laxity sometimes displayed in the matter of expenditure deserve more critical notice than has been given them Direct limitation of dividends and profits has not been enforced and the only advance made in this direction is the taxation of excess profits made during the war. In recent months, however, the Central and Provincial governments have followed the line of invigorating and intensifying the economic controls, particularly those on investment, speculation and consumption The new Defence of India Rule of the 17th May, 1943 prohibited, except with the consent of the Government, new capital issues of every kind. By a series of Orders and Notifications issued since March, 1943 by the Government, forward trading in grains, oilseeds, sugar, cotton and bullion has been prohibited The declaration and disposal of all stocks of yarn and cloth by a specified date was ordered under the Cotton Yarn and Cloth Control Order of June, 1943 and ceilings have been imposed on the prices of a large number of varieties of cloth Rationing has been introduced in some big cities like Bombay, Poona and Madras and similar schemes for several other cities may be introduced shortly In October 1943 an Ordinance for the prevention of hoarding and profiteering was passed and notifications for limiting profits of dealers in a large number of commodities to 20 per cent above the landed cost or cost of production have been issued under it Although taken together, these controls, especially the recent ones, have brought about a modest alleviation of the situation, they cannot be considered more than commendable palliatives for a malady that calls for drastic remedies

Economic controls of the kind mentioned above must form an essential part of any plan to combat inflation They are, however, like the elements of a jigsaw puzzle which must be fitted together within a composite plan to produce the desired effect There may be something to learn in this respect from the American experience which President Roosevelt conveyed to the Congress on the 7th September, 1942, in these words "Our experience has proved that a

general control of prices is possible only if the control is all inclusive Our entire effort to hold the cost of living at the present level is now being sapped and undermined by further increases in farm prices and wages and by the ever-increasing pressure of prices resulting from the rising purchasing power

It is impossible for the cost of living to be stabilised while farm prices continue to rise It is impossible to keep any prices stable if wage rates continue to rise What is needed is overall stabilisation in prices, salaries, wages and profits " Such a comprehensive scheme of economic control depends for its successful enforcement and operation on the presence of organised systems of production and distribution and on the widest public approval and cooperation Without such cooperation, the war-time economic system is like clay with lots of stones in it, refractory in parts and an intractable material on the whole With such cooperation it becomes pliant and malleable and spontaneously responsive to control and regulation [1]

Price movements and price control

The close interrelation of currency and prices and the role of price control as an anti-inflationary factor have been touched upon in the foregoing paragraphs In view of the importance of the topic, some further treatment of it at this stage appears to be necessary

Perhaps the most striking and in some ways the most far-reaching among the changes brought by the war has been the rise in prices Prices have not indeed risen continuously or steadily , sharp advance in one period has been followed by strong reverse in another, only to be followed again by a powerful and disconcerting upward thrust An examination of the price index numbers—by which changes in general price level are usually measured—for every one of the first 48 months of war will hardly yield any significant results , it is, therefore, proposed to split up the whole of this period into shorter periods in order to bring out the broad movements of prices Five periods clearly stand out and the following table

[1] *Cf* A brief discussion of the conditions necessary for the successful operation of economic controls will be found in my article on Limits of Economic Control (*The Eastern Economist*, Nov 19, 1943)

shows the magnitude and direction of price changes in each :—

Period	Duration	Index numbers in the first and last month of the period		Maximum variation during the period in points
I (4 months)	September 1939—December 1939	Calcutta (August 1939=100)	114-137	+ 23
		Economic Adviser's (Week ended 19th August=100)	108-138	+ 30
II (7 months)	January 1940—July 1940	Calcutta	130-114	− 16
		Economic Adviser's	137-111	− 26
III (10 months)	August 1940—May 1941	Calcutta	115-130	+ 15
		Economic Adviser's	110-119	+ 9
IV (11 months)	June 1941—April 1942	Calcutta	137-157	+ 20
		Economic Adviser's	126-146	+ 20
V (16 months)	May 1942—August 1943	Calcutta	169-345	+176
		Economic Adviser's	148-238	+ 90

The initial spurt in prices which lasted well into the middle of January 1940 was largely speculative in character, being based on anticipations of intensified demand and reduced supplies Partly it was due to real factors such as higher freight and insurance charges, depreciation of sterling (and therefore of the rupee) in relation to dollar, rise in the replacement cost of goods and expansion of currency

The inevitable break from the high levels reached was initiated by the announcement of excess profits tax in the third weak of January and assisted by the more determined regulation of prices by the Government The low tempo of the war upto April 1940 had as its concomitant low prices which dipped lower still after the fall of France and the consequent loss of important markets on the Continent

In August 1940, recovery in prices started at a slow and sure pace and grew quicker and more definite during the next twenty-one months Behind it was the influence of a combination of factors, the major ones among them being the large purchases of the British Government, the growing physical shortage of some goods, increasing shipping difficul-

ties, hoarding and profiteering, rising money incomes and the rise in cloth prices resulting from the hostilities with Japan

Since May 1942, prices have registered an enormous rise which originating largely from the heavy expansion of currency has been aggravated by the wild orgy of speculation in the commodity markets Difficulties of internal transport and reduced imports have contributed to the increasing complexity and gravity of the price situation Some abatement in the speed of currency expansion as well as rise in prices was noticed when the Government brought into operation after May 1943 a series of new controls on the production, sale, and movement of goods

Movements of prices during the present war furnish a striking and instructive contrast with those during the last war (See table below) Price rise was on a smaller scale and was spread more evenly during the last war A close parallel movement of prices during the two wars was, however, hardly to be expected in view of the differences in the character of the two wars, in the sequence and intensity of their varied phases and in the impact made by them on Indian economy

Prices during the two wars

(Calcutta Index Number of prices)

July 1914 = Aug 1939 = 100

Months	1st war year		2nd war year		3rd war year		4th war year	
	Last	Present	Last	Present	Last	Present	Last	Present
I	104	114	113	119	126	149	142	198
II	100	118	114	121	128	151	143	209
III	102	131	114	122	132	157	154	227
IV	104	137	116	120	140	154	171	238
V	106	130	116	121	144	155	168	250
VI	110	126	124	119	142	153	168	253
VII	112	121	122	123	141	153	177	272
VIII	108	121	123	127	143	157	176	293
IX	108	117	122	130	137	169	170	325
X	110	114	128	137	145	182	173	319
XI	111	114	127	150	137	182	172	332
XII	112	115	125	151	142	192	178	345

The various components of the general price level have not shown any uniformity of movement Some items have shown larger rise than others. In view of the present acute food situation in the country, the course of food prices is of special interest In the table below index numbers of food prices have been set against the general index number The course of prices of non-food articles can be roughly deduced from the disparate movements of the two sets of index numbers Food prices, it will be noticed, rose much less than non-food prices upto the end of 1942 but have since then and right upto September 1943 completely outpaced them

Food Prices

(Quotations for the last week of each month)

	CALCUTTA			BOMBAY		ECONOMIC ADVISER'S	
	(July 1914=100)			(July 1914=100)		(Week ended 19th August —100)	
	Cereals (8 items)	Pulses (6 items)	General	All Food (More than 15 items)	General	Food and tobacco (8 items)	General
Sept 1939	93	105	114	118	120	111	113
Dec 1939	105	119	137	132	135	127	138
July 1940	97	100	114	115	115	106	112
June 1941	114	99	137	108	127	130	115
May 1942	126	127	169	153	203	145	150
Dec 1942	250	241	238	226	266	181	186
March 1943	334	309	272	222	256	271	220
Sept 1943	530	450	349	252	244	311	241
Jan 1944	234	392	297	Discontinued		286	237

Another notable war-time development affecting prices has been the disruption of those processes by which the prices of the various commodities in different provinces and parts of the country were brought to a more or less uniform level after

allowing for cost of transport and small variations due to certain local factors affecting demand and supply Prohibitions of or restrictions on the movements of goods imposed by the Provinces and States along with difficulties of transport have led to wide divergences in the magnitude as well as the speed of the rise in the prices of the same commodity in different Provinces and States Free mobility of goods which integrates and unifies the market in normal times having been greatly hampered, the Indian market has presented the appearance of a loose and disjointed series of narrower markets The resulting price differentials have often encouraged hoarding, corruption and profiteering

During the last sixteen months a large part of the population has found itself exposed to the increasingly heavy pressure of growing scarcity and want Scarcity has manifested itself as a double-barelled problem of physical shortage and high prices and has involved the most painful reductions in the daily consumption of persons with small and fixed means In this atmosphere of unabating hardship, criticism of the policy and measures adopted by the Government naturally turned more and more bitter and destructive What has the Government been doing, it was asked, to impede the sharp advance of prices and why have they failed ?

It is hardly necessary to go into all the measures taken by the Government to control prices of various commodities Nor is it necessary to refer except in passing to the machinery set up for price control The main feature of this machinery is that the Government of India acts as the co-ordinating authority controlling prices at the producer's and wholesale stage while the Provincial Governments control them at the retail stage The Central Government have been calling from time to time Price Control Conferences to examine the situation and assist in the formulation of schemes and measures of price control These Conferences and six of them have been held so far, in October 1939, January 1940, October 1941, February 1942, April 1942 and September 1942, have been attended by the representatives of three chief units of admi-

nistration, namely, the Central Government, the Provincial Governments and the Indian States The Provincial Governments and some of the States have carried out the measures of control through the agency of Controllers of Prices functioning at the headquarters and the executive officers in the districts and local areas Price Advisory Committees have been set up in several provinces and States to assist both Price Controllers and local officials. In addition to Price Control Conferences, four Food Conferences have also been held since October 1942 to tackle the problems of the production and prices of food In December 1942, a separate Food Department was set up at the centre under the charge of the Commerce Member, and in August 1943, one of the members of the Viceroy's Executive Council was appointed Food Member and the Department passed under his charge Non-official and expert opinion has been made available to the Department through the Food Advisory Council and its special committees In July 1943, the Government appointed the Foodgrains Policy Committee to examine the past policy and present position in India in relation to the supply, distribution and price of foodgrains, and to make recommendations The report of the Committee was published in November 1943 and the recommendation and conclusions embodied in it have been made the basis of the present food policy of the Government

A bare summary of the measures taken so far to control prices should suffice to delineate the evolution of price control in this country As soon as prices began to soar after the outbreak of the war, powers taken by the Government of India under the Defence of India Rules to control prices belonging to the category of necessaries were delegated by them to the Provincial Governments by Notification No 20 of 8th September 1939 The motive behind this first application of price control was the protection of the consumer against profiteeering. Towards the end of September 1939, the replacement cost of goods *i e*, the cost at which the producer or importer could produce or replace his stock of goods along with a minimum margin of 10 per cent above pre-war prices was made the standard with reference to which the maximum

prices were to be fixed Later in May 1940, the requirement as to a minimum margin of 10 per cent compared with pre-war prices was abandoned, for it was felt that the pre-war prices did not furnish any longer a proper standard for comparison and that prices should be fixed with reference to costs after determining the latter by a careful scrutiny Most provinces, therefore, began to publish fair price lists of wholesale and retail prices for the information of the public Hoarding, refusing to sell and profiteering were all made punishable under the Defence of India Rules

On the whole it would be correct to say that until July 1941, the problem of price control did not assume any acute shape This was largely because the general level of prices after an initial rise, began to decline and though there was again a steady rise from June 1940 to June 1941, it was so gradual that it was easily acquiesced in as the inevitable resultant of a number of wartime factors such as increased war demand for certain commodities, restricted supply in certain cases, increased cost of imported materials, transport difficulties, etc Moreover, some rise in prices was even welcomed as an overdue measure of relief to the agriculturist After July 1941, however, prices of various commodities including essential foodstuffs and textiles began to rise sharply In December 1941, the maximum price for wheat was fixed at Rs 4/6 (Lyallpur and Hapur) and was revised upwards to Rs 5 in March 1942 The price of sugar was also brought under control in May 1942 A distressing development arising from the enforcement of these and other controls over prices was the transfer of the controlled commodities to the black markets, creating acute shortages in the ordinary markets The control over wheat was lifted on the 25th January 1943 and immediately stocks of wheat flowed into the markets in response to the higher uncontrolled prices But in spite of the alternation of control and decontrol and in spite of the stern though sporadic action taken against hoarders, the scarcity of food steadily grew worse and prices soared until in August 1943 scores of deaths by starvation occurred in the streets of Calcutta and revealed the gravity of the situation with painful vividness The hard core

of official complacence then began to melt and the next few months witnessed a determined drive to roll back the centrifugal forces by a series of Ordinances, directions and instructions issued by the Central Government. The first effective step in securing control over the prices of cloth was taken by passing the Cotton Cloth and Yarn (Control) Order in June 1943 and control was tightened further by appointing a Textile Commissioner who was assisted by a Textile Control Board consisting of the representatives of textile industry, raw cotton, labour, cloth trade and the consumer The Hoarding and Profiteering Prevention Ordinance was passed in October 1943 to herald the first comprehensive and serious effort to deal with the chronic evil of price ballooning by traders and profiteers

Price control, by most accounts, has been a dismal failure in India It was weak, vacillating and half-hearted and its failure was inherent in its very character Any enumeration of all the reasons for its failure would soon run into a long list but the more important reasons could be brought under the following five heads . an imperfect understanding of the principle of price control , tardiness in evolving an effective administrative machinery , lack of proper co-ordination even in such machinery as was set up , the limits to control set by the distinctive organisation of Indian economy and, finally, the uncongenial political, psychological and monetary set-up of Indian war economy. A brief study of these may suggest some useful lines of thought and action for the future

It would be hardly necessary to enter upon the definition of price control here if the whole approach to the subject did not seem to depend largely on it Price control, ordinarily understood as a body of measures to fix prices backed by the coercive apparatus of the Government, must really be defined as *the removal of the control of prices over the different sectors of a country's economy.* Now it is widely recognised that prices, which are themselves the external manifestation of numerous forces working within the economic system, exercise a profound control over a country's economy as allocators of productive resources among different uses and as regulators of production, consumption and distribution But what is perhaps not so well appreciated is the fact that price control

involves precisely the removal of this control by prices and its replacement by control of a different kind In other words, the price controlling authority must neutralize or 'sterilize' the price mechanism by reaching down to those forces that form prices themselves and bringing them under control Only after a fairly long record of failure was it realized in India that 'controls over supplies and distribution are essential and vital corollaries of price control' The importance of control over the monetary factor has also taken some time to leap to the eye On the other hand, suppression of profiteering and hoarding and control of speculation have been relied upon as the main props of price control from the very beginning

Nor has the rationale of price control been always clearly present to all minds While putting down of the middleman profiteer has been recognized as a legitimate and essential objective of price control, the agricultural interests in some provinces have looked askance at the fixation of agricultural prices as a kind of deprivation and the consumers faced with acute shortage of the commodities under control have often failed to find any particular merit in price aontrol In all this confusion, the vital issue seemed to be overlooked that removal of price control means the restoration of the control of prices over economic activity and that this removal was opposed to the whole logic of war economy, for war economy by its very nature is an economy consciously planned and directed by the state to achieve a single unified objective, *i e*, victory, and obviously a controlled economy and uncontrolled prices go ill together

This imperfect insight into the forces at work was, of course, not a little due to the absence of any accumulated body of experience and knowledge handed down from the past There was, therefore, bound to be a certain amount of feeling of the way and groping about But the changes in price situation since the outbreak of war have themselves been of such a nature as to induce at first complacency and relaxation of effort and then to demand, with the crack of a whip, as it were, swift and resolute action It is obvious that the best period for framing plans and formulating procedure for price control was from January 1940 to October 1941,

when the price situation was easier and inexorable events did not press for hasty and improvised solutions It is interesting to observe that this was also the period falling between the second and third Price Control Conferences. As a matter of fact, every worsening of the price situation in India has been marked by the calling of a Price Control Conference and the history of price control may be said to be very largely the history of decisions taken by the Conferences and the subsequent action of the Central and Provincial Governments on them There was no single comprehensive and co-ordinated plan drawn up and enforced with the co-operation of the public to meet a situation of grave difficulty both for the Government and the people On the other hand, centrifugal forces were allowed to have their sway and more latitude than was warranted by the facts of prevailing situation was allowed to the Provinces, States and even districts in controlling prices and transfrontier movements of food-grains.[1] Furthermore, programmes for the acceleration of production and regulation of consumption were pondered over and laboured until the storm was on the country. Quick changes continued to be rung in the composition of the Viceroy's Executive Council and the responsibility for feeding the country passed from one member to another like a shifty shuttlecock, telling visibly on the firmness and continuity of policy

A successful policy of price control presupposes not only an effective machinery of price control but also a clear conception of 'fair price' and the establishment of suitable parities between different groups of prices Furthermore, it requires the determination of the number and range of prices that will be brought under control In any economy subject to the change and flux of the dynamic conditions of war, the determination of fair prices is bound to be a difficult task but in India it has not been squarely faced A systematic machinery for investigation into the farmer's

[1] Recently, however, there has been a significant reversal of policy and the Central Government has by bold self-assertion been able to make the Provincial Governments agree to a uniform policy in the matter of price control and rationing

costs or the parties between different sets of prices—those, for example, of food articles and non-food articles, of raw materials and manufactured goods, of prices in one area and another area—has been conspicuous by its absence The unfortunate consequence of it has been that when the prices of articles not subject to control moved upwards, they tore asunder the ceilings or maxima imposed by the controlling authority on the prices of other articles Perhaps nowhere was it more evident than in the case of control over prices of foodgrains like wheat, without a corresponding control over prices of minor foodgrains or those of goods consumed by the cultivator. The question whether price control should be comprehensive (*i.e*, a blanket control) or selective has also not been finally answered in this country. The logic of control leads, of course, to an ever widening extension of its scope—from the price of one article to that of its substitutes and satellites, from the price of a manufactured commodity to that of the raw materials entering into its composition and from the prices of goods in general to the prices of the services of factors of production, *i e*, wages, rent, interest and profits—until it covers every price in the whole national pattern But the administrative difficulties of such a control would be formidable Nor are all prices which make up the price system equally important There are some prices which have a strategic value in the sense that they exercise a decisive pull on the whole price system, for example prices of food-grains, wages and rents, and these cannot be left out of the scope of any well-conceived price control scheme Moreover, a comprehensive control of all prices in India had a greater chance of success if it had been applied at an early stage when prices had not had a chance of raising one another by mutual stimulation. But at a late stage and particularly with an expanding currency circulation constantly blowing up the 'blanket', it may transgress the bounds of an administrator's legitimate ambition Related to this blanket *versus* selective price control issue in India is the statutory *versus* ceiling price issue In respect of the major foodgrains, the verdict of the majority of the Foodgrains Policy Committee has gone in favour of statutory price

control[1] The statutory price control, according to the Committee, "takes the form of enacting legislation prohibiting a seller from taking, or a buyer from offering, more than a given amount, or of legislation prohibiting a buyer from offering, or a seller from taking *less* than a certain amount" The system of ceiling prices, on the other hand, "is a form of market manipulation, in which the Government abstains from purchasing when the price touches a certain figure, in the hope that its purchases are such a large proportion of the total that the price will fall below the ceiling limit." Now, both statutory and ceiling control require certain conditions to be fulfilled if they are to be effective Neither of them can be made effective if the fundamental forces of supply and demand are not brought under control Statutory control has the merit of fixing a definite price and thereby discouraging the tendency on the part of producer or seller to withhold stocks in the expectation of a future rise Two objections may be raised against it firstly, its failure in the case of wheat in the past has prejudiced its case and, secondly, it cannot be made effective without an effective control over supply. These objections do not very much damage the case for statutory control because it is possible to steer clear of the mistakes made in the past by instituting an efficient machinery for the procurement of foodgrains, controlling simultaneously the prices of a number of foodgrains as also those of non-food articles, controlling the movements of foodgrains, taking deterrent measures against the hoarders, setting up government reserves of foodgrains and finally by vesting in the Central Government the right to suggest the levels at which prices should be fixed and the changes that should be made in them[2] The ceiling system has no doubt the advantages of not being rigid and not bringing the law into contempt through its failure but one essential condition for its success

[1] *Report of the Foodgrains Policy Committee*, 1943 p 85

[2] The Foodgrains Policy Committee recommended the appointment of a small Standing Prices Committee representative of the Centre, the Provinces and States, agriculturists and trade to review periodically the price situation and suggest changes in prices The recommendation will be shortly given effect to by setting up a Price Advisory Committee

is govermental possession of or control over a very large part of the total supply and this may not be capable of being easily satisfied in India

Given a proper comprehension of the principle of price control, an efficient administrative machinery and a suitable co-ordination of price parities, an effective system of price control is not impossible of achievement in India But it is necessary to recognise some of the limitations and difficulties of the task in this country Some of these are such as cannot be easily overcome but others are amenable to remedial treatment The large size of the country, the small, individualistic and unorganised character of production and trade agencies and the very large number of small agricultural producers whose operations are not easy to bring under control set definite limits to the achievements of price control in India These difficulties are more or less basic but there are others which have arisen largely during the war Among these, the foremost is, of course, the large and continuous expansion of currency[1] Price control like other forms of economic control is no doubt itself an anti-inflationary factor but without monetary control no control over prices can be sustained for long It is well-known that beyond a certain stage inflationary expansion of currency creates a vicious spiral of rising prices which feed on themselves and against which price control provides no effective check[2] Difficulties of transport are another factor in the situation but their general effect is to create local shortages—of *some* commodities in *some* areas—and cause a rise in their prices Again, speculation complex with which the markets are periodically seized accelerates the upsurge of prices And

[1] Dishoarding and dissaving by certain classes of persons during wartime has also been mentioned as a price-raising factor (*Cf* V K R V Rao *War and Indian Economy*, p 168) It is difficult to assess the magnitude or effect of this factor but it must be comparatively a very small factor in the total situation

[2] In the Indian Economic Conference held at Madras in December 1943 it was mentioned by Mr S K Rudra Secretary and Economic Adviser to U P Government, that in some *mandis* of U P, the prices of the same article vary according to the media of payment used, being higher for currency notes and lower for rupee or small coin

finally and above all the political situation in the country is not helpful to the spread of that popular enthusiasm and the willingness to view things from a larger standpoint which makes measures of governmental control less an unwanted imposition and more an acceptable wartime necessity

§5. PUBLIC CONFIDENCE AND THE CURRENCY SYSTEM

The outbreak of the present war did not cause any *immediate* panic or loss of confidence in the paper currency such as was witnessed in the early months of the last war The earliest reaction of the war on the Indian currency system was in fact a large and unprecedented absorption of currency notes.

After the first four months of war, however, a demand for rupee coin for purposes of hoarding arose. It is likely that there was some infiltration of rupee coin into private hoards occurring even during these four months, for the trend towards a large and almost continuous return of rupee coin from circulation, which had gone on since 1920-21, had been reversed as soon as the war broke out and a steady outflow of rupees had ensued But it was towards the last week of May, 1940 when the news of French reverses were received that the craze for hoarding was accentuated and turned in subsequent months into a scramble. From the 15th June to the end of August 1940, Rs 21 93 crores of notes were returned to the Reserve Bank Between 1st September 1939 and 21st June 1940, the holding of rupee coin in the Issue Department of the Reserve Bank fell from Rs. 75 87 crores to Rs 35 1 crores

To deal with the situation thus arising, the Government of India made it an offence by a notification of the 25th June 1940 for any person to acquire rupee coin in excess of his personal or business requirements This notification, while it succeeded in its objective of reducing the total demand for conversion of notes, intensified the demand for smaller coin. This necessitated the adoption of special measures The issue of small coins was limited in both Bombay and Calcutta and in Bombay small change depots were opened to cope with the rush for small coin.

The situation was greatly eased by the introduction of the Government of India one-rupee notes by an Ordinance issued on the 20th July 1940. These notes were to be current in the same manner and to the same extent and as fully as the silver rupee coin To begin with, one-rupee notes which had been printed in 1935 to meet a possible contingency but had not been used were put into circulation Later in the first week of July 1941, a new issue of the Government of India one-rupee notes printed in larger size and on better quality paper was made In February 1943, bank notes of the denomination of Rs 2 were also issued by the Reserve Bank of India

Besides the issue of one-rupee notes, other measures were also taken to deal with the situation First of all, the fineness of the silver half-rupee was reduced from 11/12th to 1/2 by an Ordinance issued on the 26th July 1940 By another Ordinance of 23rd December 1940, the fineness of the rupee coin was similarly reduced from 11/12th to 1/2

A second measure was the recall of old coins from circulation By an Ordinance promulgated on the 11th October 1940, all Victoria rupee and half-rupee coins were required to be returned by 1st April 1941 It was decided later on to withdraw King Edward VII rupees and half rupees from circulation and by a notification issued on the 4th November 1941, these coins ceased to be legal tender after the 31st May 1942 (although they could be accepted until the 30th September 1942 at Government treasuries, post offices and railway stations and thereafter, until further notice, only at the Offices of the Reserve Bank) On 1st October 1942, another Notification was issued by the Government of India calling in with effect from 1st May 1943 all George V and George VI rupee and half-rupee coins of 11/12ths fineness By two subsequent notifications of the 16th November 1942, Queen Victoria and King Edward VII standard rupees and half-rupees were declared to cease to be legal tender even at the offices of the Reserve Bank from the 1st May 1943 and George V and George VI standard rupees and half-rupees were to cease to be legal tender at the offices of the Reserve Bank with effect

from 1st November 1943.[1] Thus practically the whole of the silver rupee and half-rupee coin with the exception of the new quatenary silver coin has been demonetised

A third measure which was directed to deal with the increased demand for small coin was the issue in January 1942 of a new half-anna coin of square shape and rounded corners and made in nickel-brass alloy A similar alteration in the metallic contents of one-anna and two-anna pieces was also made and the new one-anna and two-anna pieces were issued from the Bombay Mint on the 7th March and 27th March respectively In January 1943, when the disappearance of copper pice from circulation due to a rise in its intrinsic value to the level of face value had begun to cause considerable discomfort, a new pice, less than half in weight, having a smaller diameter and a circular hole in the centre and of lower fineness was minted The new pice was issued from 1st February 1943 but owing to the unusual non-monetary uses to which it was put, its issue did not prove very helpful in improving the situation.

A perturbing development in the currency situation was the manifestation of an acute shortage of small coin in the months of October and November 1942, which caused great inconvenience to the public in making small payments Ever since the war broke out, the absorption of small coin had gone on at a rapid rate but the rate became almost phenomenal in the first half of 1942-43. The total amount of small coin (excluding half-rupees) absorbed since the outbreak of war upto the end of 1942-43 was Rs 15·9 crores of which Rs $3\frac{3}{4}$ crores were absorbed in the first half of 1942-43 and another Rs $4\frac{1}{2}$ crores in the latter half A *communique* of the Government of India issued on the 27th November 1942 attributed the prevailing scarcity of small coin to hoarding, though it was recognised that a part of the increased demand for small coin had been due to the increased economic activity in the country, the acceleration of public works, and the large disbursements to the military forces maintained

[1] The total amount of silver coin including half-rupees quarter rupees and one-eighth rupees withdrawn from circulation during 1939-43 aggregated 88 crores of rupees.

in India But even hoarding, as was pointed out, can be of two types, one prompted by fear and the other motivated by a desire to make profit The main contributory factor according to the Government of India to the prevailing scarcity of coin was hoarding for profit, either with a view to the sale of small coin at a premium or, as in the case of pice, in anticipation of a rise in the price of metal to a level which might make coin-melting profitable. This kind of speculative hoarding could be discouraged only by public vigilance and co-operation between the Government and the people to expose the activities of the profiteers The remedy for the other and the less vicious type of hoarding, that is the one prompted by fear, was the restoration of public confidence in the small coin position as a whole and in the Government's capacity to meet all reasonable small coin requirements The magnitude of the Government's effort in this direction can be estimated from the fact that by December 1942, the Government mints were turning out small coin at the rate of 72 million pieces a month and by the end of March 1943 at 136 million pieces a month as against a monthly average of 16 million only in August 1939.

Though the small coin position is now somewhat better, it has not shown any decisive improvement and local shortages do appear from time to time in a disconcertingly acute form While the Government has endeavoured to put down hoarding by making acquisition and possession of small coin in excess of personal or business requirements a penal offence, the people have tried to make their own adjustments to the new situation by using improvised substitutes such as postage stamps and coupons and by varying the size of their purchases.

§6 Disposal of Sterling

Another development, besides the heavy currency circulation, which not only affects vitally the present but holds far reaching possibilities for the future is the large accumulation of sterling balances as a credit item in India's balance of payments A part of the accumulated sterling has already been utilized for effecting repatriation of India's sterling debt

and the disposal of the remainder is at the moment subject of acute discussion and considerable difference of opinion. These two aspects of the disposal of accumulated sterling—the solved past and the unsolved future—will have to be kept distinct for purposes of study.

Sterling accumulated in very large amounts with the Reserve Bank of India largely as the result of a favourable balance of trade and the war purchases made by the British Government in the Indian market both of which were paid for in sterling in England.[1] This led to the adoption of a large scale programme by the Government of India for the repatriation of India's sterling debt. It may not be supposed that repatriation (which simply means the substitution of rupee liabilities to residents for sterling liabilities to non-residents) commenced only after the war, for it had in fact begun to be effected some two years before the war. The amounts repatriated in the pre-war period were, however, small and the schemes under which they were repatriated were voluntary in character. Even after the outbreak of the war, these schemes remained in operation for a year or so but after February 1941, two compulsory schemes were brought into operation and it is under these that almost the whole of the sterling debt of India has now been repatriated.

The total sterling debt of India inclusive of railway stocks, debentures and annuities was £356 million or Rs 475 crores at the end of 1936-37. Of this £307 26 million was repatriated upto the end of March 1943 including £261·62 million of dated and undated sterling loans and £45 64 million of Railway Annuities and Railway Debenture Stock in the manner indicated in the following table .—

		Face Value (£ million)
Open Market Purchases	.	49 74
License Scheme of 22nd January, 1940	.	2 02

[1] The sterling payments by the British Government and sterling purchases made by the Reserve Bank during war (upto March 1943) amounted in all to Rs 958 crores of which Rs 380 crores were utilised for repatriation schemes

Compulsory Schemes	
First	74 58
Second	135 28
Funding of Railway Annuities	27 06
Repatriation of Railway Debenture Stock	18 58
Total	307 26

Repatriation of sterling loans of the face value of over £260 million has been carried out by three methods (*i*) open market purchases of sterling (*ii*) the license scheme and (*iii*) compulsory schemes Under the open market purchases which commenced in 1937-38, were suspended in 1938-39 but resumed the next year, £49 74 million of debt was repatriated The Reserve Bank was authorised under this system to purchase Indian sterling non-terminable securities in the open market out of its surplus sterling balances and to transfer the securities so purchased to the Government for cancellation In their place additional rupee paper of 3½ per cent and 3 per cent non-terminable loans was created which was issued gradually by the Bank in accordance with the requirements of the market The second method *i e*, of license system was introduced on the 22nd February 1940 and £2 02 million sterling were acquired under it It consisted in offering the holders of all sterling loans the option of converting their holdings into rupee securities The rupee counterparts of six India terminable sterling loans were created and the holders of the loans were given the option of transferring their holdings from the books of the Bank of England to the Rupee registers of the Reserve Bank The difference between the two methods *i e*, the open market purchases and license system consisted in this that while under the first method the securities were purchased for cash and the Reserve Bank had to use its sterling balances, under the second, the holders were given the option of conversion and, therefore, the use of sterling balances was not required The third method of repatriation, *i e*, of compulsory schemes, was used in February and December 1941 and £209 86 million of sterling debt was repatriated by this method upto the end of March

1943. Under the *first compulsory scheme* brought into effect from 8th February 1941, the British Treasury issued a vesting order on the 7th February 1941 requiring all residents in the United Kingdom to surrender their holding of India's terminable sterling loans at prices fixed on the basis of market price on the 7th February and the Government of India issued a notification to the same effect requiring residents in British India to surrender their holdings of these sterling loans, payment being offered in rupee counterparts or cash at the holder's option The following loans were covered by the scheme 5% 1942-47, 4½% 1950-55, 4½% 1958-68, 4½% 1948 53, 3½% 1954-59 and 3% 1949-52. The total amount of debt repatriated under this scheme upto the end of March 1943 was £74·58 million The *second compulsory scheme* which was announced on the 24th December 1941 covered the following non-terminable sterling loans. 2½ per cent stock 1926, 3 per cent stock 1948 or after, and 3½ per cent stock 1931. Notice for the repayment of the 3½ per cent stock 1931 having a nominal value of £77 million was given to the holders and vesting orders were passed for the other two loans requiring their surrender and providing for the payment of purchase price in the same manner as under the first compulsory scheme Upto the end of March 1943, £135 28 million of these loans had been repaid

Besides this repatriation of sterling loans extending over a period of four years, £47 26 million of sterling balances have also been used during 1942-43 to fund the sterling obligations in respect of Railway Annuities and to repatriate Railway Debenture Stocks

Repatriation of sterling has had a very marked effect on the composition of India's public debt, the sterling portion of the debt having been very nearly wiped out and the rupee portion having more than doubled The total sterling obligations were at the end of 1936-37 and 1942-43 Rs 493 crores and Rs 90 crores respectively, the corresponding figures for rupee obligations being Rs 707 crores and Rs 1299 crores

The following table shows the changes in the composition of India's public debt —

	1936-37	1938-39	1943-44 (Revised)	1944-45 (Budget)
	(In crores of rupees)			
In India —				
Loans	437 33	437 87	1,004 14	1 303·94
Treasury Bills and Ways and Means Advances	28 54	46 30	127 70	127 70
Unfunded Debt	219 93	225 13	221 80	274 41
Deposits (Depreciation and Reserve Funds)	20 82	27 34	131 47	214 66
Total Obligations in India	706 62	736 64	1 485 11	1,920 69
In England —				
Loans	400·96	396 50	13 83	13 83
War Contribution	22 29	20 62	20 62	20 62
Railway Annuities	53 15	47 82	32 78	29 45
Unfunded Debt	16 67	4 18	3 65	3 60
Total Obligations in England	493 07	469 12	70 88	67 50

Process of the Finance of Repatriation of Sterling

There are two stages in the operations by which the repatriation of sterling has been financed In the first stage, sterling is acquired from the Reserve Bank to pay off the holders of sterling stock and in the second stage, rupees have to be obtained to pay for the acquired sterling The first stage has presented no difficulty because the Reserve Bank had ample resources in sterling which were made available to the Government The second stage, however, has been more complex because of the difficulty of borrowing immediately large funds in the Indian market Operations of various kinds have been used to cover this stage To the extent to which the sterling loans were held by Indian investors, direct payment has been made in the form of rupee counterparts As regards the remainder of the loans, it was either taken over by the Reserve Bank in the form of counterparts or was met out of Government balances or financed by *ad hoc* Treasury Bills and Ways and Means advances from the Bank A part of the rupee counterparts of the repatriated sterling stock has been cancelled because it was considered to be in excess of the absorptive capacity of the Indian market Cash payments on account of the cancelled counterparts were made almost entirely out of the Defence Loans proceeds Of the remaining counterparts, more than Rs 50 crores were taken

by the public in the form of existing loans For the balance, rupee resources have been found from the Treasury Bills taken by the Reserve Bank, Ways and Means advances from the Bank, and Government balances The amount of Treasury Bills sold to the Issue Department of the Reserve Bank and the Ways and Means advances taken from the Bank both increased greatly as a result of the financing of the repatriation operations [1] A natural consequence of the operations has been an increase in the rupee debt of the Government of India and in the rupee interest charges. "It is difficult to state with precision to what extent the funding of floating debt raised for the purpose of repatriation has been achieved . . . The broad position may be said to be that of some Rs 400 crores raised so far for financing the various repatriation and funding operations, only Rs 160 crores may be regarded as being still in the form of Central Bank finance, since that is the amount by which the rupee securities held by the Reserve Bank as cover against its note issue exceed the corresponding figure at the outbreak of the war"[2]

Critical Appraisal of Repatriation Operations

There is hardly any difference of opinion that the repatriation of sterling debt has been a well-timed and successful operation and has brought solid gains both to the United Kingdom and India. The gain to United Kingdom consists in the release of sterling resources which can be mobilised by the British Government for investment in British war loans. The gain to India lies, in the words of Sir J Raisman, Finance Member, "in the liquidation of external obligations which might prove an embarrassment in future and their

[1] To facilitate repatriation operations, the Reserve Bank of India Act was amended in 1941 so as to enable the Bank to hold three-fifths of the total assets in the Issue Department in the Government of India rupee securities The provision in Section 33 (3) of the Act that the amount of such securities cannot exceed one-fourth of the total amount of assets or fifty crores of rupees, whichever amount is greater, was waved

[2] Budget Speech, 1943, para 47

replacement by internal debt" There has also been a substantial but temporary gain to the Indian revenues in so far as the holders of sterling stock have been paid out of the short term obligations contracted by the Government of India at low rates of interest But the more important and permanent gain to Indian revenues accrues by the heavy reduction in, what are known as, Home Charges The virtual disappearance of these charges removes one of the complicating factors in the Indian currency system Furthermore, the Government of India will now have to raise large rupee funds in India and this should impart the much needed strength to the Indian gilt-edged market which has suffered in the past from a plenitude of resources and inadequate demand Above all, the repatriation of sterling has enabled India to pass at a stride, as it were, from the position of a debtor to that of a creditor country

Some doubts have been raised about the effects which large scale repatriation transactions may have on the sterling reserves of the Reserve Bank and through them on the value of Indian currency and on the credit of the Government of India Whatever validity these doubts may have had in the past, they have none now that the Bank's assets are groaning under the weight of superabundant sterling. A more pertinent criticism of repatriation operations has been that the Government failed to purchase sterling loans at the most favourable rates and thus made these operations unduly expensive This, however, overlooks the fact that sterling loans could be purchased or paid off only when the Government of India had sufficient amounts of sterling at their disposal and these did not accumulate until some time after the war[1] In any case, there does not appear to have been any wasteful negligence on the part of the Government in carrying through these operations

Future of Sterling Balances

The manner of the disposal of sterling balances during the

[1] For an illuminating argument on this point by Sir J Raisman in reply to J M Mehta, see *Leg Ass Debates*, 1942, vol. I, pp 778—87,

last few years arouses now far too little comment compared to the question of their future utilization. For, substantial amounts of sterling—of the value of about Rs. 900 crores—still await disposal and more are likely to accumulate under the financial arrangements in force for the duration of war. The Government have already decided to liquidate the Chatfield Debt of one quarter of £34 million, being India's share of the estimated pre-war capital cost of modernising the Indian army. They have also in hand a scheme for utilizing a part of the accumulated sterling to create a fund which may be used to meet their obligations on account of sterling pensions, family pensions and provident funds[1] The remainder of the sterling accumulations embodying as they do the sacrifice of consumption of the Indian people in the past and present and representing their claim on the products of the labour of other peoples in the future will have to be so liquidated that the structure of Indian economy receives the maximum nourishment and strength and the fabric of world economy suffers the least possible injury.

It may be suggested here that some definite lines must be laid down in advance to regulate the use of sterling balances in post-war years Clearer visualisation of the future of these balances has become urgent in view of the penumbra of suspicion and fear gathering round them Apprehensions appear to be gaining strength in some quarters that the perfidious Albion may by a sleight, as it were, sweep all the balances out of existence. Several dark possibilities are being hinted at. It is said, for instance, that the Government will just watch the balances being squandered away by continuing the statutory obligation imposed on the Reserve Bank to maintain the 1*s.* 6*d* rate *i e* a rate which will be rendered wholly untenable and obsolete by the post-war relationship of British and Indian price levels Another possibility indicated is the revision or re-interpretation of the Financial Agreement governing the allocation of war expendi-

[1] The approximate amount that would be so utilized was given by Mr C E Jones, Finance Secretary, as £150 million (*Times of India* dated 2nd September, 1943)

ture in such a manner that India finds the remainder of sterling balances just enough to clear off the heavy debts on account of her share of war expenditure[1] or, alternatively, India may be got round by wily means to make a big gift to the United Kingdom as a token of goodwill and comradeship-in-arms It is also being hinted that under the post-war monetary system, plans for which are already being prepared, India's sterling balances may be cleared out of the way as a deadweight on international trade and an obstacle to fruitful international economic collaboration Then there is the fear that sterling may grossly depreciate bringing down the commodity return for the balances Further, it is said that even if the balances remain intact and are liquidated in full, the speed at which they are released for realization may be very slow and the purposes for which they can be utilized may be severely restricted in practice

It is not difficult to detect in these speculations, not all of which can be brushed aside as rambling or wild, the shadow of the unpleasant memories of the past There is the obvious reluctance to believe that a war contribution (of £100 million in the last war) and the dissipation of sterling resources through an ill-advised attempt to maintain a high exchange ratio (as in 1920) are episodes that belong to the dead past and cannot be repeated in future

Even if all the fears inherited from the past are not projected into the unknown dimensions of the future, ceaseless

[1] Apprehensions regarding this possibility were raised by some unnecessary and unjustified statements in some British papers (*Cf Economist* 7th August 1943) to the effect that India has become a creditor of England not through the normal processes of trade and investments but through negotiated division of defence cost. India was said to have driven a hard bargain and the Financial Agreement was represented as being very liberal to India and less than fair to England In this matter it is difficult to arrive at any conclusion on economic considerations alone India's capacity to pay for the defence measures undertaken by her may be measurable in economic terms—and it is well known that it is none too large—but no one can seriously suggest that India should be called upon to pay to the utmost limit of her capacity except on the strict assumption that every defence measure for which she has to pay was also undertaken solely in her own interest. That assumption, however, will be widely questioned in this country

vigil may still be necessary to ensure that in the rush of post-war adjustments the pitch is not so queered for India that her hard won foreign resources are whittled away Five eventualities will have to be guarded against In the first place, no revision or further interpretation of the Financial Agreement regarding allocation of defence expenditure between England and India should be permitted to augment India's share of the total financial burden of war. Secondly, no post-war currency plans which prevent the fullest and free-est utilization of sterling balances should be subscribed to Thirdly, no financial or commercial arrangements among the victorious nations or between England and India should be allowed to impair India's liberty to utilize her sterling resources to purchase such goods and in such countries as she decides upon in her own interest.[1] Fourthly, any loss to India from depreciation of sterling must be made good by the British Government as part of a bargain in which the debtor pays a commodity debt unimpaired in amount by a change in prices [2] Fifthly, no relaxation of the control over the exchanges should be allowed until a suitable parity of the rupee in relation to sterling has been determined after taking into account the relative price levels and other basic facts of the economic relationships of the two countries

It may be pointed out that these general considerations do not touch the really basic problem of the *transfer* of these resources to India. Such transfer will, of course, be made and received in the form of goods and services but that only means that the time, manner, form and conditions of the

[1] It was mainly this consideration that aroused opposition to the otherwise excellent suggestion made by Sir J Raisman in his Budget speech (March 1943) for the institution of a post-war Reconstruction Fund The Fund was to be constituted by setting apart a portion of the accumulated sterling and was to be utilized after the war to purchase machinery and other industrial equipment.

[2] Mr G D Birla has suggested in this connection that sterling balances should be linked up with the U K commodity price index number so that if the prices in United Kingdom rise, i e, if sterling depreciates, the amount of sterling balances should be raised proportionately (*Cf* his article on *Our Sterling Balances* in *The Hindustan Times* of March 27, 1943)

transfer will have to be settled Commercial and economic opinion in this country appears to be unanimous that a large part of the sterling resources should be obtained in the form of capital goods, particularly industrial plant, machinery and durable consumers' goods This will have the double advantage of facilitating renewal, repair and replacement as soon as the stress of war production is over and of providing the necessary elements for a large industrial expansion Sometimes, however, this mode of transfer is recommended with such extravagant emphasis as to give rise to the impression that by the end of the war India will have completely terminated her dependence on other countries for all the consumers' goods It would appear to be wiser to concentrate the force of agreed opinion on the demand that India should be left free to obtain such kinds of goods as the demands of her economy dictate, a very large proportion of these goods being necessarily capital goods The speed at which the transfer takes place will necessarily depend upon the time taken by the economies of England and other countries to complete the transition from war production to peace production A number of other adjustments will also have to be made before an export surplus is built up by England on the basis of an improved technique and lower competitive costs and sets into operation the necessary transfer of resources Corresponding to the export surplus built up by England in relation to other countries, there will be import surpluses developed by the creditor countries like India Whether, therefore, India obtains the equivalent of her sterling wholly from England or partly from England and partly from other countries whose currencies have been acquired through surplus British exports, the whole process of transfer will postulate a closer interlinking of the economic systems of different countries by a series of adjustments in prices, production, trade and exchange And this alone should serve to furnish a measure of the magnitude of India's stake in a stable economic future for the world

Mention may be made here of one particular aspect of the process of transfer on which much attention has justifiably been focussed How can the sterling which now forms

the backing behind the expanded currency be utilised without affecting the currency circulation? Does not the very fact that sterling backs the currency mean that sterling is something of an encumbered asset not freely available for use? An answer to these questions necessarily requires a clear understanding of the process by which sterling is acquired and finds a place in the assets of the Issue Department of the Reserve Bank, for it is the reversal of this process that constitutes the whole mechanism of transfer The process has already been explained briefly.[1] It consists mainly of three stages which do not appear to be so distinct in practice and may indeed occur simultaneously an *outflow* of goods and services from the country, *accumulation* of sterling with the Reserve Bank and *expansion* of currency in circulation in India creating an inflationary situation The reverse of this process should logically consist of similar three stages, *inflow* of goods and services, *contraction* of currency creating a deflationary situation and *decumulation* of sterling with the Reserve Bank This deflationary aspect of the liquidation of sterling raises a rather discouraging prospect for Indian industries and agriculture in the post-war period and means will have to be found by which to avoid it

It has been argued that this difficult situation in which sterling resources cannot be liquidated without at the same time operating on the internal currency circulation has arisen really out of the wrong course along which war finance in India has been directed If internally the whole of war expenditure (including that on behalf of the Allies) had been raised by non-inflationary methods—so runs the argument—sterling would still have accumulated to India's credit by way of payments from the Allies but as no additional currency would have gone into circulation against it during the war period, no contraction of currency would have attended its use in the post-war period

There are a few issues raised by the argument which have to be carefully examined As regards the alternation of

[1] Vide *ante*, pp 147-50

inflation and deflation, the sequence is neither so closely bound up with the liquidation of sterling resources nor is so inevitable as it might appear to be There is no doubt that the ability of the monetary authority in India to keep deflationary forces under check in the post-war period will depend largely on the magnitude and extent of inflation during the war The depth of the hell of deflation, it may be said, will be measured by the height of the heaven of inflation At the rate at which inflation has been developing in India and might develop further in the remaining war period, some measure of deflation would become unavoidable in order to restore some kind of balance between different elements of the economic system such as different sets of prices, prices and wages, money incomes and the available quantity of goods, etc

If, however, inflation is not allowed to develop further it should be possible to make all the necessary adjustments for securing the transfer of sterling to India without imposing a deflationary strain on the Indian economy One view that seems to have gained ground is that to secure a release of sterling from the assets of the Reserve Bank—without a corresponding contraction of currency in India—it would be necessary to substitute for the sterling assets *ad hoc* rupee securities of the Government of India [1] The release of the whole of sterling cannot, of course, be secured in this manner because a definite amount will in any case have to be retained as an external asset behind the rupee currency to meet all possible foreign liabilities But having allowed for this amount of the order of, say, Rs 200 crores, the remainder can be appropriated by replacing for it the rupee securities This act of replacement and the consequent change in the composition of the assets of the Reserve Bank will require an amendment of the Reserve Bank of India Act

It is desirable to state that while these adjustments will obviate the necessity for deflation, they will not *by themselves*

[1] *Cf The Eastern Economist* (November 17 and 26 and December 17, 1943) for an exposition of this view

justify the maintenance of a higher income and price level handed down by the war. The justification for that will have to come from a higher level of economic activity initiated and sustained by well-planned schemes of economic development The transfer of sterling resources need not be anything but a wholesome process if it is pressed into the service of such schemes and promotes their general purpose

There is an obvious link between the accumulation of sterling balances and the wartime changes in the distribution of wealth in India and it is, therefore, natural to ask if the inward transfer of these balances will have any bearing on the internal distribution of wealth It is well known that sterling balances have accumulated because of the outward transfer of real resources from India to service the war effort of the Allies Such transfer was bound to impose curtailment of consumption and hardships on Indian people but whether the burden of that sacrifice was equitably distributed among different sections and groups of population would have depended on the methods used *in India* for imposing it In this connection the elementary truth may be repeated that while the incidence of taxation and borrowing can be so adjusted as to correspond with the ability to pay, inflation is a wanton tax-gatherer, blind, exacting and pitiless As inflation has been employed in India in addition to taxation and borrowing as an instrument for the transfer of resources, there has developed a close connection between sterling balances and inflation. Is there, therefore, a case for using the balances after the war in such a manner that only those sections and groups of people who have suffered from inflation are made the beneficiaries? There is no doubt that changes have occurred in the distribution of wealth in India during the war—capital in the form of houses, land and hoarded precious metals has changed hands and bank balances have piled high or dwindled away—but it is difficult to say without careful investigation to what extent these changes have made distribution of wealth more inequitable *than it was before the war*. Assuming that distribution was

not so inequitable before the war as it would be at the end of it, any effort to approach the pre-war position would involve an *ex post facto* examination into the wartime vicissitudes in the wealth and property of millions of people. It would be a formidable task but then on a little reflection it may also appear to be unnecessary What the country will require after the war will be an all round energising of productive activity and it may rightly be insisted that all schemes in this regard should be carried out under the control and direction of the state in the interests of the mass of people. The state will have to look after the distributional aspects of such schemes As for the compensation of certain classes and groups who have suffered glaring injustice during the war, it is always open to the state to use the two instruments of taxation and public expenditure to secure the necessary redress In any case the suggestion that some groups rather than the country as a whole, shoud have a priority of claim over the use of sterling balances is a trifle injudicious in that it is likely to introduce rivalry of claims in a matter where unity of demand is essential

There are besides the transfer problem two other considerations regarding the growing volume and future disposal of sterling of which notice has to be taken The first concerns the purchase of foreign investments in India on private account Now that almost the whole of the sterling debt has been repatriated, the possibility of purchasing private investments in India by using the surplus sterling should be fully explored Estimates available at present of the value of these investments vary from 100 to 400 crores of rupees, which only means that no reliable estimate is available of their value or of the extent to which they have already changed hands during the war The first step in this regard should, therefore, be to prepare a list of all the private foreign enterprises in this country and make an estimate of the value of their investment After accurate data have been compiled, they should be carefully examined to decide which of the enterprises should be taken over first in the

interests of the country and to what extent persuasion or legislative compulsion would be necessary [1] The second consideration relates to the manner in which all the dollar proceeds of India's exports are taken over by the London Exchange Control and sterling given in exchange for them Whether dollar resources that would otherwise be available to India can be utilized during the war to import machinery, tools etc. may indeed be open to doubt, though in this regard the last word should rest with the United States Government (rather than the British Government.) But there does appear to be considerable force in the view that Government of India should see that " from at least now on India's favourable trade balance with the U S.A is accounted for by accumulation of dollars and not by adding to an already voluminous stock of sterling credits " [2]

[1] Reference may be made in this context to a letter (reported to have appeared recently in *Great Britain and the East*) of Sir Alfred Watson, an ex-editor of *The Statemsan*, wherein he observes that it would be ridiculous to conceive that Indian industrialists would be able to take over British enterprises in the country In support of this observation he has added that Indian investor has shown in the past more confidence in British-managed enterprises than those run by his own countrymen, that all available Indian capital will be available for starting new industries that India needs after the war that business like that of export trade cannot easily be taken over and run by the Indians and that the British employer pays better wages than the Indian and, therefore, the retention of British example in industry is necessary These are indeed wanton assertions questioning Indian employer's efficiency, concern for workers and ability to, inspire confidence As regards concern for workers, it would be easy to indulge in a tu qouqe and quote from the Report of the Royal Commission on Indian labour about the miserable conditions of workers on European-controlled and managed Assam tea plantations But a more apposite reply to give would be that the Indian industrialist cannot come into his own and display all the qualities expected from him until he is assured of a sympathetic treatment from the Government in all his genuine needs The charge about the Indian employer not being a good paymaster is, however, one which the foreigner may well be asked to forget—for it is after all indiscriminate in character and of transient validity—and the Indian employer asked to ponder over

[2] See the statement on the subject issued by Kumararajah Sir M Chettiar, President of the Federation of Indian Chambers of Commerce and Industry (*The Tribune*, dated 17th January, 1944)

CHAPTER XI

THE FUTURE

§1 MONETARY STABILITY AND THE ECONOMIC SYSTEM

The role of monetary policy in the management of the economic system which was emphasized by the Great Depression of 1929-33 has been heavily underlined by the present war There is no doubt that during war money functions more as a measure of costs and as an instrument for the required transfer of resources to war uses than as a governor of the economic system or an independent propelling force. Every effort is made to control it and make it subserve the general purpose of the war economy, for the imperative reason that the penalty entailed by failure to do so would be very heavy But this apparently subordinate role of money during war does not in any way detract from the overpowering sway it normally exercises over the economic system in regulating the direction as well as the speed of its expansion and contraction It would indeed be difficult to think of a smoothly functioning international economic system or of balanced economic advance for the world as a whole or for any individual country without properly managed money

Now that the possibility of financing a large scale total war involving tremendous financial costs without running into any major financial crisis or dislocation has been demonstrated during the last few years, there can be some reasonable ground for the belief that the management of money on an international scale—or what is the same thing, the setting up of a satisfactory international monetary system —would not be beyond the grasp of statesmen and monetary experts The money costs of the present war—leave alone the costs not measurable in money—will be found, when the final com-

putation is made, to have been staggering. They will certainly be far heavier than those of the last war which themselves amounted, according to some calculations, to over £70,000 millions A good part of these costs has been met by bringing into existence fresh stock of wealth through larger and more efficient production but a substantial part of them represents curtailment of consumption and private investment and depreciation and depletion of the existing capital equipment Taken by themselves, they would point to smaller real income and lower standards of living as the lot of large sections of the world's population after the war. The prospect is, however, not so depressing as it might appear and it was not an unduly optimistic note which Lord (then Mr.) J. M Keynes struck when he said to the British people in November, 1940 "Stop thinking that after the war we shall have to lower our standards of life. I see no likelihood of that. On the contrary I hope that we shall have learnt some things about the conduct of currency and foreign trade, about central controls, and about the capacity of the country to produce, which will prevent us from ever relapsing into our pre-war economic morass."[1] It must be obvious, however, that to achieve any large advance in the living standards after the war, a clearer insight into the working of *national* economic systems combined with a rational operation of state controls alone would not suffice , the whole of the machinery of *international* trade, exchange and investment would have to be restored and made to funtion more satisfactorily than before. Schemes of post-war economic reconstruction will, therefore, defeat their own end if they are not firmly broadbased on the widest international economic co-operation and goodwill

The foremost place in any agenda for the post-war world must, therefore, rightly be given to the institution of a sound international monetary arrangement. Proposals for such an arrangement have already been put forward by the monetary experts of Great Britain, U.S A and Canada and have been for some time under discussion These proposals are not an expression of a sudden yearning of war-weary people for a-

[1] Full text of a Broadcast reproduced in *The Statesman*, Nov 21, 1940

better monetary system, they mark, on the other hand, a further step in the intellectual process of groping, that has gone on during the whole of the inter-war period (1919-39), for a sound international monetary structure It may be helpful to review briefly the events of these twenty years as a preliminary to the statement and examination of the proposals for international currency

Among the many changes brought about by the war of 1914—18 an important one was the suspension of gold standard by most of the countries At the end of the war only a few countries such as United States and Sweden adhered to gold and that, too, more in name than in effect For over forty years gold had functioned as the common basis of currencies and provided to the world a reasonably stable measure of values as well as an integrated structure of prices and money incomes. Whether gold standard was wholly automatic in operation may be doubted but two advantages that were claimed for it by its supporters could not be denied even by its worst detractors It prevented the perpetual interference with currency systems by governments acting under political pressure and it greatly facilitated the conduct of international commercial and financial relations Besides, there was no satisfactory alternative to it in sight The only feasible course in 1918, therefore, appeared to be to heave the currencies back to stability and anchor them to gold This was by no means an easy task, for currencies broken loose from gold had greatly expanded and in some countries such as Germany, Austria and Hungary, expansion was growing into inflations of very serious dimensions bringing in its wake serious economic and social consequences The period from 1919 to 1925 was, therefore, one of confusion, uncertainty and instability accompanied, of course, by international conferences (at Brussels in 1920 and at Genoa in 1922) to formulate principles and procedures for currency reform and by policies and measures to give effect to them The general objective of the measures of currency reform was the restoration of gold standard at preferably the pre-war parity Lord (then Mr) J M. Keynes who advocated the adoption of a managed

currency at the time found very few supporters even in his home country In April 1925, Great Britain returned to gold standard at the pre-war parity and between 1925 and 1928, almost all the leading countries including France, Italy and Germany restored the gold basis of their currencies The restored gold standard functioned upto 1931 when it again broke down

Between the gold standard of 1925-31 and the pre-1914 gold standard there were important points of difference both in respect of internal structure as well as the external environment A distinctive feature of the structure of the gold standard during 1925—31 was the considerable economy practised in the use of gold in various ways by abandoning the use of gold coins, by fixing a reasonably large minimum for the amount of gold bullion which could be demanded in exchange for paper currency and by adopting the system of keeping the whole or part of the gold reserves in the form of balances in foreign countries whose currencies were based on gold.[1] Another feature was the greater element of 'management' or conscious control in contrast with the more automatic operation of the pre-war standard Under the pre-war system, export and import of gold acted as automatic correctives to exchange fluctuations and to disequilibrated balances of payment by altering the relative price levels but under the restored gold standard gold exports were 'offset' and gold imports 'sterilized' so that the disequilibrium was not speedily corrected The discount policy of the central banks, too, was not used in the same way as before the war to anticipate and prevent gold movements.[2] A further feature of the post-war gold standard was the complication introduced in its working by the short term balances—'hot money' as they

[1] But in spite of these economies, the view was held that reserve ratios of central banks were too high and that the world production of gold was not keeping pace with the demand for it Moreover there was a maldistribution of gold creating scarcity in some countries *Cf* Cassel's *Crisis in the World's Monetary System*, 1932 also Gregory *The Gold Standard and its Future* 1934, pp 36-37

[2] Robbins *The Great Depression* p (28 et seq) In U S A complaint was made that the pound went off gold in 1931 with the Bank rate at no more than 4½ per cent

came to be called—held by countries in general in other countries Whenever confidence was shaken by political uncertainty or other causes, these balances were moved from one country to another, causing gold outflows and disturbing, even imperilling, the whole basis of currency and credit Equally great was the complication caused by the adoption of exchange parities which either over-valued or under-valued the currencies of different countries and caused the greatest strain on their balances of payment Moreover, the dominating position which London held before 1914 as the financial centre of the world was undermind after the war so that the excess and deficit balances on international account of different countries could no longer be cleared with the former facility or automatism But, perhaps, even more important than these structural changes in gold standard was the wholly transformed environment in which it was to function. It was an environment highly charged with economic nationalism and characterised by an all round rigidity of costs, prices and interest-bearing obligations Gold standard, as is well known, is a symbol as well as an instrument of monetary internationalism and can hardly fit in with narrow nationalistic commercial and monetary policies Nor does it fit in with a whole complex of valorisation schemes, monopoly price fixations, cartels, pools, trade union-controlled wages and inelastic governmental expenditure, for it demands a fair measure of flexibility in the matter of the adjustments of domestic prices, wages and contractual obligations to the fixed norms of exchange

It could not be expected that set in the context of such conditions the gold standard would function smoothly or effectively It is possible, however, that it might have continued to function a little beyond 1931 had the Great Depression which started in 1929 not released forces which hastened its downfall The heavy fall in prices, particularly of agricultural commodities, put a heavy strain on the balances of payment of debtor countries and led to the intensification of trade and exchange restrictions culminating in defaults, moratoria, depreciation of currencies and abandonment of gold

These measures taken by the debtor countries had their inevitable repercussions on other countries and led to defensive action on their part Great Britain who was finding her gold reserves running down due to withdrawal of short-term funds and was experiencing, with an over-valued pound, an adverse trend in her balance of payments sought relief by departing from gold standard on September 21, 1931 This became a signal for other countries to leave gold or devalue their currencies A bloc of European countries comprising France, Belgium, Netherlands, Italy, Switzerland and Poland, however, decided to stick to gold standard. Germany also remained on gold though only in a nominal sense. Defections from the gold bloc began to take place from 1934 onwards and by the end of September 1936, the last fortresses of gold had surrendered Taken as a whole, the decade from 1929 to 1939 was characterised by a decided trend towards disintegration of international monetary relations and the growth of a network of nationally controlled and operated systems, devices and arrangements such as exchange control, exchange clearing and stabilisation and equalisation funds [1] That the statesmen and thinkers were not unaware of this trend or of its definitely depressing effect on trade and production was evident from the attempts that were made at intervals to find a basis for international monetary stabilisation.[2] Though no international agreement could be reached in this regard, monetary stability was attained over limited areas by setting up currency blocs (such as the sterling area) and by arriving at currency agreements among groups of countries

From this brief review of the monetary developments of the two decades of inter-war period it would be clear that the smooth flow of economic operations is both a necessary condition and a natural result of a smoothly operating in-

[1] Ropke gives a succinct analysis of this trend and its effects (*Cf* his *International Economic Disintegration*, 1942, pp 191-97)

[2] For example the World Monetary and Economic Conference held in London in June 1933 had currency stabilisation as the chief item on its agenda and in 1936 the Tripartite Currency Agreement signed by U S A, France and England established *de facto* dollar-franc-pound exchange stability

ternational monetary mechanism. The synchronisation of periods of rapid economic expansion with monetary stability and those of slow advance with monetary instability is not fortuitous The tidal sweeps in the volume of business activity, the alternation of prosperity and depression, which lend to the economic system an appearance of chronic instability can be attributed very largely to monetary causes Even when they are not so attributable, they may be found to be amenable to treatment by monetary remedies

Reference may be made here to one fact of considerable significance Even during the period of the suspension of gold standard, the economic and monetary thought (as reflected in the published works of major importance) was concentrated more on analysing and defining the conditions necessary for its restoration than on discovering a substitute for it[1] Among these conditions were included the satisfactory settlement of war debts and reparations question, the removal of the odius prohibitions, restrictions and restraints on international trade, the restoration of the automatic action of gold movements on price levels, continuous co-operation among the central banks to lower their reserve ratios and for other matters of common concern, control over the movement of short term foreign balances and also over the volume of foreign lending and a direct attack on the rigid elements in the national economic structures The discovery of means by which the demands of internal wage, investment and employment policies could be harmonized with the fixed exchange rates of the gold standard was indeed considered one of the primary pre-requisites for going back to gold Given these conditions, gold standard could be successfully re-established , without them, all talk of gold standard or, for that matter, of any international monetary system was useless After all, the world could not have an international monetary system ' unless it showed itself deserving of it by manifesting a truly international spirit '

[1] An alternative to gold standard—which implies both stable *and* free exchanges—was of course a regime of stable but *controlled* exchanges but the latter could hardly be called a substitute for the former

Gold standard, whatever its shortcomings, had the merits, given certain conditions, of being international in character, impersonal in management and automatic in operation [1] These minimum qualities must belong to any institutional arrangement that may be set up to take the place of the old gold standard But there are a few more norms in terms of which such an arrangement may be judged For instance, it will be expected to carry through smoothly the transition from war to peace And when that has been accomplished, it will have to provide a smooth and effective procedure for clearing international balances of payment, ensuring the unimpeded flow of capital to the less developed areas of the world and assisting in bringing about a steady and unbroken advance in the material standards of living all over the world Furthermore, it must be neutral between creditors and debtors, must not be linked too closely to gold and must not hamper, by imposing uniform rates of economic advance, rapid economic progress of the less developed areas of the world

From these general observations, one may pass on to sketch short outlines of the three currency plans.

§2 THE POST WAR CURRENCY PLANS AN OUTLINE

The three post-war currency plans separately drawn up by the British, American and Canadian experts are an earnest of their desire to protect the peace from currency chaos and muddle and place it on an enduring foundation. They are declared to be tentative and provisional and subject to modification and the American plan has already been reissued twice in a revised form All of them present in clear outline the administrative arrangements for operating an international monetary system Combining broad features with fairly profuse detail and representing, as they do, a new

[1] One of the obvious shortcomings in the mechanism of the gold standard was that if the gold-receiving country began to 'sterilize' gold, the automatic check to gold inflow did not operate so that the gold-losing country went on losing gold until it rescued itself from the disaster of falling prices shrinking money incomes and growing unemployment by going off gold.

venture of thought into the field of economic internationalism, they provide a somewhat taxing reading To bring out the distinctive features of each plan, a good part of the details will have to be cut out

The British Plan

The British Plan[1] which bears the stamp of the genius of the eminent British economist, Lord Keynes, recognises in its Preface that the mechanism of currency and exchange is only one among the four main lines of approach to the task of post-war reconstruction, the other three being commercial policy, production, distribution and price of primary commodities, and international investment[2]

The Plan sets before itself the objective of providing a *mechanism* of international currency, which is non-political, elastic and equilibrating in character[3] It seeks to create a *substance* of international currency which is not subject like gold to the unpredicable fluctuations arising from changes in world production of gold and the gold reserve policies of different countries The concrete mechanism proposed in the Plan is an International Clearing Union and the unit of international currency, *Bancor*

The (proposed) International Clearing Union will be an international organisation with the United Nations as its original members, the other States, including the ex-enemy States, being invited to join subsequently - Members can withdraw from the Union on a year's notice provided they have made arrangements to clear off their debits with the Union The direction of the affairs of the Union will vest in a Governing Board appointed by the Governments of the member States The responsibility of each member in the management of the Union will depend on the *quota* assigned to it, this *quota* being a kind of numerical measure fixed with reference to the sum of each country's pre-war exports and imports[4]

[1] *Proposals for an International Clearing Union*, 1943

[2] *Ibid*, Preface [3] *Ibid*, 1-4. [4] *Ibid*, 6 (1), (2), (5), (12) (16)

The (proposed) international currency will be *Banc* the value of which will be fixed in terms of gold by t Governing Board of the Union and which will be accept by all the members of the Union as the equivalent of go for the purpose of settling international balances. Tl initial values of the currencies of member States in terms bancor will be settled by agreement and no subsequer alteration will be allowed without the permission of tl Governing Board of the Union No member State wi purchase or acquire gold at a price which does not corre pond to the value of its currency in terms of bancor and th value of bancor in terms of gold. A member state will b entitled to obtain a credit balance with the Union in term of bancor by paying in gold but will not be entitled t demand gold against a balance of bancor.[1]

The centre of interest in the Plan is, of course, the metho of operation, the procedure by which the debit and credi balances on international account will be cleared off by th member States of the Union. The essential idea underlying the Union is to extend the principle of banking as exhibited within an isolated single nation to the wider international field. The credits and debits, by this principle, will necessarily be equalised because both the creditor and the debtor will receive and make payments within the orbit of an international monetary institution, namely, the Union A creditor State will accept payment of currency balances due to it from other States in the form of a credit balance of bancor in the books of the Union A debtor State can likewise borrow bancor from the credit balances of any other member State[2]

Thus the Union will not have, to start with, any resources of its own, though it may later on come in possession of gold tendered to it by member States to obtain a credit balance in bancor Its constant endeavour will be to keep both credit and debit balances within limits and to check the excessive accumulation of both types of balances by various devices such as by levying a charge on any debit or credit balance exceeding a certain amount, granting permission to a

[1] *Ibid*, 6 (3), (4), (10) [2] *Ibid*, 5, 6 (6)

debtor State to depreciate its currency upto 5 per cent of its value, demanding from the debtor State for a deposit of suitable collateral such as gold against its debit balance, and lastly, by recommending to both creditor and debtor States various measures to improve or adjust their balances on international account To the accumulation of debit balances a maximum, equivalent to the *quota* of each country, is laid down, for the credit balances there is no such maximum, though the liberty of the creditor country to employ some of its favourable balance of payments in ways other than building up a bancor balance is not restricted [1]

The position of the Central Banks of member States is in no way adversely affected by the Plan The Clearing Union will in fact be set up not for carrying through daily transactions between individual traders and banks but for clearing and settling balances between Central Banks It will not stand in the way of member States maintaining intimate currency relations with one another on a group basis if they so desire Private holdings of foreign currency, private dealings in exchange and international capital movements will be allowed freely if they are approved by the member States concerned But steps will be taken to ensure that reserve balances of countries are kept as far as possible in bancor and not in dollars, sterling or other currencies [2]

The position assigned to gold in the Plan is naturally of the greatest interest Bancor—the international currency—will be equivalent to a certain (not unalterable) weight of gold and as the currencies of member States will be linked to bancor, they will necessarily have a defined gold content This gold content will determine the official buying price for gold in the national currency of a member State There will be one-way convertibility between gold and bancor, for, while a credit in bancor can be obtained by giving gold, gold will not be available for reduction of bancor credit except at the discretion of the Union For the rest, the countries can maintain their separate gold reserves and export and import gold In short, 'the purpose of the Clearing Union is to sup-

[1] *Ibid* 6 (6)—(10), 7-8

[2] *Ibid*, 19-25

plant gold as a governing factor, but not to dispense with it'[1]

The Union set up under the Plan does not involve, though it is expected to facilitate, control of capital movements and removal of dislocating trade restrictions and exchange controls by different countries. It will aid in the transfer of abnormal war balances so as to prevent excessive strain on the debtor country[2]

Several advantages are claimed for the British Plan and many ambitious hopes are entertained of its potentialities for good The most important among the advantages is the expansionist influence of the Plan on world trade and economy. The credit balances in bancor under the Plan correspond to import of gold by the creditor countries under the gold standard but whereas imported gold may cause a reduction in the total purchasing power and exercise a deflationary pressure on the whole world, bancor balances do not In the transitional post-war period when the debtors on international account may not be able immediately to build up export surpluses, the facilities provided by the Plan will enable the debtor countries to avoid unnecessary and deflationary curtailment of imports The Plan will, moreover, be helpful in financing programmes of post-war relief and reconstruction and if operated in conjunction with other plans for investment and commodity control may smooth out the alternations of boom and depression[3]

The American Plan

The preliminary draft of the U S. Plan[4] worked out by Mr. Harry White, Monetary Advisor to the U. S Treasury Department, was put forward in April 1943, a revised draft in July 1943 and a second revised draft in August, 1943 The provisions of the Plan in its first draft may be briefly stated before noticing the changes made in the revised versions

The Plan is drawn up with reference to three objectives; *viz*, to prevent the disruption of foreign exchanges,

[1] *Ibid*, 26-31 [2] *Ibid*, 22, 23, 33, 35, 37-38

[3] *Ibid*, 10-18, 39, 41-42

[4] *United States Proposal for a United and Associated Nations Stabilization Fund*, 1943

to avoid the collapse of monetary systems in the post-war period, and to facilitate the restoration and balanced growth of international trade It proposes, like the British Plan, the establishment of an organisation called the United and Associated Nations Stabilization Fund and the creation of an internationally acceptable unit of currency called 'Unitas'[1]

The Fund will be constituted of gold, currencies of member countries and securities of member Governments Each member country will subscribe to it its 'quota' which will be a certain amount of gold, its own currency and its government securities The quota will be determined by a country's holdings of gold and foreign exchange, the extent of fluctuations in its balance of payments and its national income The aggregate of all the quotas will be equivalent to at least 5 billion dollars[2]

The Fund will be administered by a Board of Directors to which each Government will appoint a director and an alternate The Board of Directors will select a Managing Director and one or more assistants Voting power in the Board will be closely, though not proportionately, related to the quotas of member countries, but no country can have more than one-fourth of the total votes Decisions, except where otherwise provided, will be by a majority A country failing to meet its obligations to the Fund may be suspended by a majority vote but while under suspension it will be subject to the same obligations as any other member of the Fund Any country may withdraw from the Fund by a two years' notice[3]

The unit of account of the Fund will be the 'Unitas' which will be equivalent to $137\frac{1}{7}$ grains of fine gold or 10 U. S dollars In terms of this 'Unitas' or gold, the value of the currency of each member country will be fixed by the Fund and no member country may alter it without a four-fifths majority of member votes This provision, it will be noticed, is intended to secure the stabilization of exchange rates between currencies of member countries and to prevent competitive depreciation[4]

[1] *Ibid*, Introduction [2] *Ibid*, II. [3] *Ibid*, V [4] *Ibid*, IV

Closely akin to this provision is the one by which each member country will undertake to abandon, as soon as conditions permit, all restrictions and controls over foreign exchange transactions. Each member will also undertake not to alter exchange rates fixed by the Fund except with the consent of the Fund and only to the extent and in the direction approved by the Fund. Further, each member country will undertake not to enter into any new bilateral foreign exchange clearing arrangements or multiple currency practices except with the approval of the Fund. Each member country will also co-operate effectively with other member countries for purposes of regulating international movements of capital in accordance with the Fund's recommendations [1]

The Fund will enjoy fairly wide powers It will buy, sell and hold, gold currencies, bills of exchange and government securities of member countries. It will accept deposits and earmark gold It will act as a clearing house for settling international movements of balances, bills of exchange, and gold. It will fix the rates at which it will buy and sell currencies of member countries for one another or for gold. Changes in these rates will be permitted only when they are essential to the correction of a fundamental disequilibrium and are approved by four-fifths of member votes [2]

The Fund will advise countries as to the ways of restoring their dislocated balances of payment to the equilibrium position. Specific limits are laid to the extent to which it will sell foreign exchange in return for the home currency of a country and as those limits are approached, the conditions of sale will be made more and stringent If any currency which the Fund holds becomes scarce, its sales among the countries wanting it will be apportioned. If the Fund's holdings of a country's currency are getting depleted quickly (because of the creditor position of that country), the Fund will render a report and also make recommendations to the country concerned regarding the restoration of its balance of payments [3]

The Fund will buy under specified conditions from the Governments of member countries abnormal war balances held

[1] *Ibid* VI [2] *Ibid*, III, 1-2 [3] *Ibid*, III, 3-7

in other countries The specified conditions provide that the country selling the abnormal war balances will repurchase 40 pe cent of them from the Fund over a period of 23 years, anotherr 40 per cent of them being purchased over the same period by the country where they are held, the remaining 20 per cent being partly cancelled by levies on creditor and debtor [1]

The Fund will deal with and through only the treasuries, stabilisation funds, fiscal agents or central banks of member countries and with international banks owned predominantly by member Governments [2]

Gold occupies a fairly dominant position in the Plan The quota of each country which will determine its voting rights and status will consist to the extent of 12½ per cent of gold, though countries having less than 300 million dollars in gold and less than 100 million dollars in gold may respectively provide only 7 5 per cent and 5 per cent of their quotas in gold 'Unitas'—the international unit of account—will, it appears, have a two-way convertibility into gold, Unitas being convertible into gold and gold into Unitas [3]

First Revised Draft—The first revised draft of the American Plan introduces some important modifications in the original proposals Among these, one that has provoked the sharpest criticism in the British press is the change in the composition of quotas subscribed by member countries from 12½ per cent in gold to 50 per cent in gold Another modification is to the effect that the rates at which the Fund will buy or sell members' currencies will be fixed at the value of the currencies concerned in terms of the U S dollar on 1st July 1943 A further modification provides that exchange rates in the first three post-war years can be changed by a simple (instead of 4/5ths) majority vote and that any country can during this period change its rate by 10 per cent either way after consultation with, but not necessarily with the approval of, the Directors of the Fund The Revised Plan also lays down that the decisions of the Board will be taken by three fourths (or 75 per cent) majority instead of four-fifths majority and no

[1] *Ibid*, III, 9 [2] *Ibid*, III, 16 [3] *Ibid*, II, 4, III, 1

country can have more than 20 per cent of the total number of votes Another important modification is to the effect that the Fund will purchase during the first two years of its operation abnormal war balances to the extent of not more than 10 per cent of the quotas of all member countries and will after two years propose a plan for further gradual liquidation of such balances. The gold value of the international currency unit—Unitas—can be changed, under the revised plan, by a 85 per cent vote The advances permitted to deficit countries have been limited further and subjected to more stringent conditions.

Second Revised Draft —According to such reports as are available, the second revised draft provides that only those countries whose gold and free exchange reserve exceed thrice their quota will have to pay 50 per cent of their quota in gold, others paying between 30 per cent and 50 per cent according to their holdings in gold and foreign exchange Countries which have suffered from enemy occupation will pay three-quarters of the above percentages They will also fix their own exchange rates, which the fund will accept, before it commences its operations in these countries Some calculations regarding the distribution of voting power under this draft place the share of the British Empire at 20 per cent (Great Britain alone at 10 per cent.), United States, 20 per cent; Russia, 6 per cent, China, 3 per cent and India, 2 6 per cent [1]

The Canadian Plan

The Canadian Plan for an International Exchange Union has emerged from a critical examination of the British and American Plans and claims to incorporate important features of both along with the addition of certain new elements [2] In the general observations made on the two Plans which precede the outline of the Canadian proposals, considerable stress is laid on the view that international monetary organisation, though a logical and convenient starting place for

[1] *Vide Commerce* dated 9th and 16th October, 1943

[2] *Tentative Draft Proposals of Canadian Experts for an International Exchange Union*, 1943

joint international action, cannot by itself provide a solution for several vital problems such as commercial policy, international investment and prices of primary products Such an organization, it is further held, should not be called upon to finance measures for post-war relief and rehabilitation It should be 'international rather than supernational', based on agreement for common purposes and advantages, permitting quick withdrawal to any member choosing to do so and allowing the greatest scope for the pursuit of national economic policies in the interests of national welfare Above all, it must make effective provision for the extension of credits to countries so that they may get time to make the necessary adjustments in their balances of payment without having to take recourse to bilaterally balancing trade and credit agreements That inevitably means that its resources must be ample, though these resources should not be used to cover up deep-seated and chronic maladjustments [1]

The International Exchange Union proposed in the Plan aims at providing an orderly mechanism for the determination and stabilisation of exchange rates, clearance of balances in international payments, the provision to all countries of sufficient resources in foreign exchange, the achievement of international equilibrium by preventing excessive short-term borrowing and excessive accumulation of idle foreign balances, and the re-establishment and development of a multi-lateral trading system [2]

The resources of the Union, aggregating $8,000 million, will be subscribed by the member countries by way of quotas, the amount of the quota of each country depending on such factors as international trade, national income, and holdings of gold and foreign exchange convertible into gold At least 15 per cent of the quota will be payable in gold and the balance in national currency. To countries having less than $300 million in gold or foreign exchange convertible into gold, time may be given to pay up their gold contribution Quotas of particular countries may be changed from time to time, though no increase in the quota of any country will

[1] *Ibid*, 1-13

[2] *Ibid* I

be made without the consent of its representative The Union will have the right to borrow domestic currency from member countries in amounts upto 50 per cent of their quotas All gold and foreign exchange which a member country acquires in excess of the amounts held immediately after joining the Union will be sold to the Union, on its request, in exchange for local currency or foreign currencies [1]

The monetary unit of the Union will be an international unit (called provisionally the Unit) consisting of $137\frac{1}{7}$ grains of fine gold Its value in terms of gold will not be changed without a four-fifths majority of member votes Member countries will fix in agreement with the Union the initial values of their currencies in terms of gold or the Unit and will undertake not to alter these values without the approval of the Union except in cases when they are considerable net purchasers of foreign exchange and are entitled on that account to depreciate their currencies by 5 per cent (or even more with the approval of the Union) Deposits in terms of the Unit may be accepted by the Union against delivery of gold They will be transferable to other countries, will be redeemable in gold and have a 100 per cent gold backing [2]

The Union will be administered by a Governing Board to which each Government will appoint a representative and an alternate The Governing Board will select a Governor and one or more assistants In the Union, each country will have 100 votes plus one vote for the equivalent of each 100,000 Units of its quotas Decisions, except where otherwise provided, will be taken by a majority. Countries failing to meet their obligations to the Union may be suspended by a majority vote and dropped one year after suspension unless restored to good standing by a majority vote. Countries may withdraw from the Union by giving notice which will take effect on the expiry of a period the length of which will depend on whether the country has been a net purchaser of foreign exchange or not.[3]

The Union will fix, on the basis of exchange rates initially agreed upon between it and each member country,

[1] *Ibid.*, II [2] *Ibid.*, III IV [3] *Ibid.*, IX-XI

the rates at which it will buy and sell member currencies for one another and the rates in local currencies at which it will buy and sell gold To secure equilibrium in the balance of payments of member countries, it will adopt slightly different but equally effective procedures for countries having a deficit balance and those having a surplus balance *In relation to deficit countries*, the Union will sell to the Treasury or Central Bank of the country concerned currency of any country held by it (Union) in order to enable the country to meet an adverse balance of payments on current account. Sale of foreign exchange for domestic currency will be limited in general to 200 per cent of the quota of a member country But much before this limit is reached, the Union will adopt various measures to secure the deposits of gold and acceptable foreign exchange from the country concerned and to bring about restoration of the disequilibrated balance of payments *In relation to the surplus countries*, the Union will, as soon as the currency of a member country has been sold to the extent of 85 per cent of its quota, render report to the country about the causes of the depletion of its holdings of the Union and recommend measures for restoration of equilibrium It will also borrow additional supplies of the currency of such a country, arrange a programme of capital investment by it and also ration the supplies of a scarce currency [1]

Member countries of the Union will agree not to impose any restrictions on the use of the Union's holdings of local currencies for purposes of payments within the countries They will also undertake to abandon, as soon as conditions permit, all restrictions on foreign exchange transactions other than capital movements and to abstain (except with the Union's approval) from bilateral exchange clearing or multiple currency practices [2]

Regarding abnormal war balances, the Plan provides that during the first two years of operation the Union will have the right to purchase such balances in amounts not exceeding in the aggregate 5 per cent of the quotas of all member

[1] *Ibid*, V VI [2] *Ibid*, XII.

countries. The balances thus bought may be exchanged either for the national currency of the country to whom the balances belong or for foreign exchanges needed to meet current account deficits. At the end of two years of operation, the Governing Board of the Union will propose a plan for the gradual further liquidation, in whole or in part, through the Union, of the balances [1]

§3. THE CURRENCY PLANS AN APPRAISAL

The currency proposals outlined above and the discussions centering round them have set people thinking mainly along two lines On the one hand, greater thought is being bestowed in the Allied and neutral countries on the need and possibility of evolving a suitable international monetary system and, on the other, each country has been suddenly called upon to think a little more clearly about the future of its own currency vis-a-vis the proposed or possible international monetary arrangements In India also, thought has been running along these two lines but does not seem to have reached so far (as was perhaps inevitable) the stage of final or even preliminary formulation of views by the Government of India The merits and drawbacks of proposed currency plans have been, and are being, carefully analysed and appraised At the same time, an endeavour is being made to visualise more precisely the future of Indian currency system, the principles that should inform its regulation and the technique that should be brought to bear on its management The specific issue as to what attitude India should adopt regarding the currency plans is also being carefully examined The two lines of thought are, in fact, not wholly unrelated because an international monetary organization that fails to function effectively in the international sphere but conforms to Indian requirements may not serve this country any better than another that functions effectively but does not directly promote the objects cherished by India There is no reason, however, why an international monetary organization should

[1] *Ibid*, VIII

not be flexible enough to serve both types of ends

It will be rash just at present to venture anything more than a tentative opinion on the various aspects of monetary arrangements proposed in the three currency plans The plans are provisional and are undergoing continual revision and any firm basis for final judgments is lacking [1] But it would hardly be correct to make all judgments wait upon their taking the final shape For the plans do reveal even in their present form the distinctive lines of thought among the monetary experts in different countries Moreover, they have been laid open to the searching eye of scrutiny long enough for preliminary judgments to be framed and general attitudes to be defined.

Largely it is true that a currency plan can establish its merit only by its actual working and by its intrinsic strength to overcome the difficulties it encounters But it is clear that it will not be given a chance to work at all unless it evokes the widest confidence and acceptance among the countries of the world by its proposals and provisions A comparative appraisal of the three plans has, therefore, to be made and this may be done with reference to the following ten items (1) aims and objectives of the plans, (2) nature of the proposed international monetary organisation, (3) conditions of membership and management, (4) the mechanism for correcting disequilibrium, (5) the position of creditor and debtor countries, (6) the position of gold, (7) the provisions for fixation of exchange rates and for exchange depreciation, (8) control of exchange and capital movements and adoption of protective devices (9) finance of post-war reconstruction, and (10) transfer of abnormal war balances

It may be pointed out at the outset that the Canadian Plan is very largely an elucidated version of the American Plan though it incorporates some features of the British Plan besides some of its own All the three plans have a fundamental similarity in their aims and objectives in that they seek to establish an international monetary machanism which

[1] It is not unlikely that the currencv plans may fade off like the Cheshire cat leaving behind only a grin !

will secure exchange stability, assist in the development of international trade and allow sufficient scope to the countries to carry out policies for attaining a high level of employment and incomes In matters of organisation and procedure, however, they considerably differ. The Clearing Union of the British Plan will not have any resources of its own to start with unlike the American Stabilisation Fund or the Canadian Exchange Union both of which will have ample resources of their own derived from the contributions of members This does not mean that the British Union will be organisationally less secure , for the manner of its operation will be quite different from that of the American Fund. It may, however, be admitted that the possession of resources does inspire a greater sense of security and in this respect the American Plan may well appear more attractive As regards membership rights, share in management and benefits extended by the monetary institution, the British Plan has the merit (from the standpoint of a large number of countries) of not putting a premium on the possession of large quantities of gold But it does tilt the balance of advantages in favour of certain countries—for example, Great Britain herself—by basing rights and privileges on figures of foreign trade The American Plan does not offer a similar simple formula for determination of rights but is all the same less than fair to countries not possessing large stocks of gold When a number of countries have to be brought into the international monetary institution, it will, of course, be difficult to devise a basis for membership rights which will satisfy all or will not weight the scales in favour of some and for quite a considerable time the Governing Board of the institution will be on trial for its impartiality and disinterestedness All the three plans envisage a division of the countries into members and non-membets but do not make clear the extent of membership that will be necessary to make them workable This recognition of non-members coupled with the facilities for members to withdraw from the monetary organisation seems to open the door to a disastrous breakdown as in the case of the League of Nations.

The central features of the Plans are those relating to correction of disequilibrium in the balance of payments and the position of creditor and debtor countries The emergence of a position of disequilibrium—of surpluses and deficits on current account—is inseparable from a dynamic international economy and all the currency plans provide for its correction in a manner which does not overstrain the economies of countries or disrupt the international monetary arrangements The British plan allows a debtor on international account to run into deficits upto a specified limit—upto the full amount of its quota, though it will bring into operation various correctives much before that limit is reached The American Plan similarly allows a debtor to go into deficit —*i e*, buy foreign currencies by paying up gold or its own currency—up-to a maximum of 200 per cent of its quota [1] and provides for the application of checks before that limit is reached As regards creditors on international account, the British Plan sets no limit to the accumulation of credits (except that it provides for a small charge of 1-2 per cent per annum on bancor balances exceeding a certain amount) Advice will, however, be tendered by the Union as soon as the credit balance of a country exceeds half of its quota as to what measures it should take to reduce its export surplus or increase its long-term lending Under the American Plan (where the mechanism is such that the accumulation of credits in foreign currencies by a country is accompanied by the depletion of the Fund's holding of that country's gold and currency), the accumulation of credits is limited to the initial contribution to the Fund But the Fund can replenish its holding of a country's currency by borrowing with the consent of the Government concerned, *i e* the limit to the accumulation of credits can be extended If, however, the Fund finds its holding of a currency running out, it can resort to a rationing of that currency, that is, it can (indirectly) restrict the right of other countries to make purchases in that country.[2]

[1] The limit can be exceeded on approval by four-fifths member vote provided some specified conditions are satisfied

[2] The Canadian Plan, which also provides for rationing of scarce

The American Plan, therefore, provides for a more limited accumulation of credit balances by a country or, what amounts to the thing, a more limited accumulation of debit balances by other countries to it. There is some justification in this sense for describing it as a 'creditor's plan'. Similarly, the British Plan which does not restrict *in the same manner* the acccumulation of credit balances of a country (*i e.*, debit balances by other countries against it) may with some truth be called a 'debtor's plan'. The point is of very great practical importance because after the war a number of countries would be anxious to make large purchases in the United States and would like to avail themselves of a method of payment which does not impose deflationary pressure on their economies. This would be possible only if the United States makes it possible for other countries to obtain dollars by either selling goods to her or borrowing from her or by paying up their own currencies which will accumulate as a credit balance in favour of United States in an international monetary institution Another point to note is that under the American Plan, the ability of a creditor country to make purchases from another creditor country is much less than under the British Plan. A bancor balance with the Union can be used to make purchases in any country but the Fund will provide freely only those foreign currencies of which it has a goodly amount (*i e.*, of debtor countries).

Gold is assigned a place of honour under all the three plans but perhaps more so under the American and the Canadian than the British Plan Under the British Plan there is one-way convertibility of gold, for while *bancor* can be had freely in exchange for gold, gold will be given out only to creditor countries (at the discretion of the Union) in extinction of their surpluses Under the American Plan, a part of the initial contributions to the Fund will be made in gold and the Fund can buy and sell gold and accept deposits

currencies, goes a step further in making it clear that restrictions imposed by member countries on the imports of goods from a country whose currency is rationed will not be regarded as constituting an infraction of the most favoured nation obligations of commercial treaties (except under certain conditions)

in gold It is not clear, however, whether the Fund *must* accept gold in exchange for unitas deposits and thus ensure two-way convertibility of gold The international currency unit will be equivalent to a defined quantity of gold under all the plans but while the gold equivalent of *unitas* and *unit* is specified in the Plans, that of *bancor* will be fixed by the Union Under all the schemes the gold equivalent is alterable—a necessary and admirable provision for insulating the world price and credit structure from fluctuations in world gold production[1] As all the Plans provide for the fixation of the initial exchange rates of member currencies in terms of the international currency unit, the exchange rates of currencies in terms of one another and in terms of gold will be settled simultaneously The fixation of initial exchange rates of currencies will, of course, demand the greatest care and in this respect the British Plan and the revised American Plan allow scope for adjustment in the first few years of the operation of the Plan The American Plan will, however, fix them to begin with at the level ruling in July 1943 In the matter of the depreciation or appreciation of exchange, the original American Plan is more rigid than the British or the Canadian Plan both of which provide for appreciation as well as depreciation, the extent of depreciation being 5 per cent for a debtor country without consulting the monetary authority and more in consultation with it The first revised version of the American Plan, however, does tone down the rigidity by providing for a 10 per cent change either way in exchange rates In appraising this provision of the Plans, it may be borne in mind that some amount of latitude in the matter of exchange depreciation (or appreciation) will have to be allowed if countries in different stages of economic development and having different rates of economic advance are to be brought together within the frame work of an international monetary organisation It is, of course, true that the wider

[1] To regulate the purchasing power generated by the system itself the British Plan provides for reduction and restoration of the quotas of member countries The American Plan also provides for changes in quotas but is less elastic on the whole in respect of this provision

and more general this latitude, the less is its utility to countri who need it most

In respect of exchange control, the plans show con[illegible] able divergence The American and the Canadian [illegible] envisage an early abandonment of all restrictions and contr over foreign exchange transactions (other than those involving capital movements) and also prohibit new bilateral exchange clearing and multiple currency practices while the British plan considers further extension of exchange control "consonant with the general purposes of the Clearing Union" and envisages the continuance of currency blocs of countries like, for example, the sterling area. As regards the control of capital movements by the national governments, the British Plan affirms its necessity but does not consider it essential to the operation of the Union while the American and Canadian plans make definite provision for it As regards protective devices such as import duties, barter trade agreements etc., the British Plan contemplates their adoption under certain circumstances but expects countries not to have them as a general rule. The American and the Canadian plan do not make any mention of them.

The plans also differ as regards the extent to which the proposed international monetary organisation will be called upon to assist in the task of post-war relief and reconstruction The British Plan provides for grant of overdraft facilities by the Union as a substitute for or as a supplement to any alternative provision for relief finance. The American plan envisages a separate agency for the purpose while the Canadian plan is definite that any monetary organization which is set up should not be called upon to finance relief and rehabilitation Obviously the American and Canadian Plans are in this respect more sensible The Plans, however, agree in recognising that separate agencies will be necessary to provide long-term finance and stabilise the prices of primary commodities.[1]

[1] An agreement to set up a separate relief organisation called the United Nations Relief and Rehabilitation Administration was signed on November 9, 1943 The resources of the Administration will be derived

The problem of liquidating postwar balances has engaged attention in all the plans but the American and Canadian plans are more definite in their proposals in this regard than the British The British Plan mentions the need of some provision by which the Union could help in converting these balances into bancor without imposing an excessive strain on the bancor resources of the debtor country The American and the Canadian plans, on the other hand, lay down a detailed procedure by which the monetary authority might purchase a portion of these balances from the country to which they belong, and then the country where they are held as well as the country transferring them might re-purchase them from the monetary authority over a number of years [1]

The general impression one is left with after a perusal of the plans is that the British plan has a larger element of flexibility and demands in some respects a smaller restriction of the area for national economic policies and national discretion than the American The American plan, on the other hand, appears to have a solid structure and faces up to some issues with greater directness Both are necessarily coloured by the general outlook of their framers regarding currency problems Both embody long-term proposals and do not address themselves to the problems and conditions of the confused transitional period of the early post-war years

§4 THE FUTURE OF INDIAN CURRENCY

Before attempting an outline of the future of Indian currency in the setting provided by the monetary developments of the inter-war period and the currency plans, reference may be made to the fact that the structure of Indian currency

from the contributions of the member governments and will be fixed, it is understood at 1 per cent of the national income of each country (For full text see *Indian Information*, Dec 1943) Draft proposals for a World Capital Bank with a capital of $10,000 million and £3,000 million respectively have also been put forward by American and Canadian experts to provide for long-term finance

[1] The proposals embodied in the Currency Plans in this regard have been given in full in Appendix D

itself has changed somewhat under the impact of war Th is a far bigger element of control in it than there ever w before the war To a far greater extent, it has come to res on a base of virtually inconvertible paper Indeed the d monetization of nearly the whole of the silver rupee coin an the smooth passage of one-rupee and two-rupee notes into circulation would have been considered revolutionary changes under different circumstances The vast expansion of note issue has already reacted powerfully on the internal value of the rupee and may, as soon as wartime controls are relaxed, pull down its external value also. The accumulation of large sterling balances in England has created the twofold problem of the preservation of their value and their inward transfer The rupee-sterling link, however, remains intact and so also India's membership of the sterling area

These changes have occurred against the general background of some, but on the whole inade quate, industrial expansion, increasing absorption of the country's economic resources for the acceleration of war effort, the resulting scarcity of essential consumers' goods and considerable economic dislocation causng hardship to large sections of population.

There are three periods into which the future of Indian currency may be divided for the purposes of the present brief study : the unexpired portion of the war period , the transitional period immediately following the end of war and the post-transitional period of reasonably assured peace and reconstruction

In the immediate future the most outstanding problem of Indian currency will be, as far as one can see, one of bringing and keeping the inflationary forces under control Another smaller problem may be shortage of small coin but that need hardly require so much anxious thought in solution Inflation, however, has a far-reaching bearing on the future of Indian currency and it is necessary to ensure that the war does not bequeath to the future a very much inflated structure of money prices and leave behind the most complicated problems of the restoration of budgetary equilibrium and the determi-

nation of suitable exchange parities

One of the immediate issues to be faced in the post-war transitional period in India will certainly be the retention or relaxation of exchange control—and the extent of it The economic systems of different countries will then seek freer inter-communication and it will have to be decided how far and on what conditions Indian economy should go back within the orbit of the world economic system. To a large extent the position would appear to be pre-determined by the rupee-sterling link and India's membership of the sterling area But if the Indian economy is not to be left to the mercy of forces released by the war, the whole question of rupee-sterling link will have to be brought under examination at the earliest possible date The preamble to the Reserve Bank of India Act envisages the consideration of a suitable monetary standard only when the international monetary position has become sufficiently clear and stable This condition, if strictly observed, will involve postponement of decision on several vital issues of currency The presence of several inelastic items of cost in the economic organization of India requires, however, that freedom to control exchange and alter exchange rates should be assumed at the very commencement of the period of transition The same course of action is enjoined also by the urgent necessity of preserving such industrial expansion as has been secured under the stimulus of war demand There is also the further consideration that if conditions of slump succeed the cessation of hostilities, a fixed and over-valued rupee exchange will communicate their depressing effects to the internal economy with added intensity

Freedom and flexibility in respect of exchange are likely to to be needed in equal measure in the post-transitional period of reconstruction For whatever be the shape of the world monetary system of the future, Indian currency will have to be pressed into the service of all those policies and measures that are formulated to build up the standard of living of the large poverty-stricken mass of Indian people It is, therefore, necessary to form an idea of the relation in which the future Indian currency system should stand to the future world monetary system and to the internal economy of India

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The future monetary system is likely to be either some form of gold standard operated without the agency of an international institution or a managed system of international curency linked to gold and operated by an international institution The only other alternative – and this is not being ruled out—is for countries to preserve autonomous currency policies or organise themselves into currency blocs, that is, reproduce the kind of systematised chaos that prevailed during 1931-38. It does not appear that gold will lose its dominant position as a money-commodity easily or quickly. This would suggest the importance of conserving and building up the gold reserve behind our paper currency in order to settle balances of payment on international account. Actually, however, India's position after the war should be of a strong creditor who could, if she so chose, ask for payment of her dues in gold. For India, therefore, accumulation of large gold stocks would be unnecessary for international purposes and inexcusably wasteful for internal use. Internally, the Indian currency of the future should be a cheap currency, largely of paper, backed by a moderate quantity of, but not convertible into, gold and operated in solely the national interest by the central banking institution Its specific objective should be the promotion of the highest level of employment, production and trade within the country. Externally, there should be the fullest liberty to retain or abandon the link with sterling and the membership of the sterling area

In the absence of an international monetary agreement, the link with sterling may not necessarily be a liability for India provided it is voluntarily determined and established. There is no doubt that in the period following the abandonment of gold in September 1931, sterling behaved well and was a haven of refuge for several currencies How strong sterling will be in the post-war period is still an open question [1] But India's trade relations with England as well as the

[1] "There is for example the much discussed problem of pound sterling Unless the volume of British export can be increased by something of the order of a half, the British international accounts will not freely balance '—(*Economist* August 28 1943)

accumulation of large sterling balances to her credit are important considerations which may weigh in favour of maintaining the sterling link The rupee-sterling parity, however, is a somewhat different matter. The parity will have to be determined afresh in the light of conditions prevailing after the war, and will have to be so chosen that the rupee is neither overvalued nor undervalued

India's general attitude towards the currency plans will be influenced a good deal by the consideration that for her it is better to be an independent member of an international organization than a subordinate member of the sterling area But she need not be in a haste to join any international organization unless she finds the terms of admission honourable and the advantages of membership substantial She must also weigh carefully the disadvantages of joining an unsuitable international organisation against the disadvantages of keeping out and pursuing an autonomous monetary policy. Among the various courses available to India, an easy one would be to try to find a niche in the monetary mansion, in the construction of which she has no share and in the management of which she has but a feeble voice Neither by her position as an important belligerent nor by her potential economic strength should she be driven to such an ignominious course But much will depend on the clash and balance of political forces in the post-war period and on, India's capacity to break through the obstacles that beset her path and take her political destiny in her own hands

Now as regards conditions of membership and share in management, it does not appear that under any of the three currency plans India will enjoy any weight in the counsels of the proposed monetary organisation. On the contrary, she will occupy, as far as one can see, a very subordinate place As regards the gains (and losses) flowing from the membership of an international organization, several vital considerations have to be kept in view. In the first place, a free multilateral process of trade which is the aim of all the three currency plans to restore and promote may not necessarily be beneficial to India Several reservations in respect of the freedom of our future commer-

cial policy will have to be made if an energetic programme of industrial expansion is to be brought into effect in the post-war period. In fact, there may be something to be said in favour of taking no definite decision on currency plans until some agreed plan for the conduct of post-war commercial relations is forthcoming. A policy of autarchy or narrow self-sufficiency may not be in the interests of this country and the advantages of free-est commercial inter-communication among nations may be worth preserving But the paramount aim of this country should be to accept no commitments that restrain the adoption of an economic policy which contributes towards the elevation of the miserably low standards of living of the vast mass of population A second vital consideration for India is a satisfactory provision in a world currency plan for the disposal of the wartime balances built up by her in sterling Very great importance has come to be attached to these balances because they represent in the main the transfer of the resources of India for Allied use during the war and the consequent heavy sacrifice of consumption made by the Indian people and are not, as is sometimes sought to be made out, an incidental outcome of the allocation of war expenditure between England and India No currency plan that permits the impairment of the value of these balances or places impediments in the way of their speedy realization has the slightest chance of acceptance by Indian economic and commercial opinion Equally important for India is the free convertibility of her sterling balances into other currencies, particularly dollars Under the American plan, it has been mentioned earlier, there is a provision for rationing of scarce currencies From India's point of view, an arrangement by which the dollar portfolio of the monetary organisation is placed at a substantial amount and is prevented from running out quickly and which ensures free convertibility of sterling into dollars is to be greatly desired A third consideration is that it will be necessary for India when she joins the international organization to assume complete liberty of action in the matter of membership of the sterling area The linking of the rupee to an international currency unit should be

accompanied by a break with sterling except for such purposes and at such rates as may be provided for in the plan In choosing the initial exchange value of the rupee, care will have to be taken to ensure that the rupee is not overvalued or undervalued Passing to the fourth and the last consideration, it may be added that an agricultural country like India has a number of rigid elements in her economic structure and an urgent issue in the post-war period will certainly be the maintenance of agricultural prices in India in parity with agricultural costs India may, therefore, prefer the flexibility of the British Plan to the rigidity of the American Plan in the matter of exchange control and alterations in foreign exchange rates. Here again there should be a strong disposition to wait until the outlines of an international plan for the control of commodity prices have been drawn up [1]

These are some of the minimum requirements of an international currency plan from the Indian point of view It may be argued by some persons that the construction of an international monetary system involves a policy of give and take on the part of individual nations and that it would be unfair for India to stand out for the satisfaction of all or even

[1] It may also be desirable to define India's attitude to the two other organisations i e, a World Capital Bank and the United Nations Relief and Rehabilitation Administration As regards the World Capital Bank, India's general attitude should be to favour the establishment of such an organisation but as the discussions on the schemes of the Bank have not reached a mature stage, a clearer formulation of views about them would be premature As for the U N R R.A, India has already signified its general approval of it, for the Agreement for setting it up was signed by Sir G S Bajpai on behalf of India, subject to ratification by the Indian Legislature Indian opinion was considerably agitated when in the Council session of U N R R A held in November 1943, it was declared that the relief of famine areas in India did not fall within the scope of the Administration's activities But since then the Bill relating to U N R R A has been passed by the United States House of Representatives and Senate with an amendment to the effect that any area important to the United Nations military operations which may be stricken by famine or disease shall be included in the benefits through the U N R.R A" The amendment is likely to be accepted by the Council of the Administration This coupled with the report that India is free to suggest the contribution to the Administration in the light of her per capita income and expenditure incurred on famine relief, has gone far to allay India's apprehensions

most of her demands as a price of joining up. This argument overlooks one material fact. The expansion of world trade and the utilization of world's resources speed each other up by a mutual stimulation and create the reservoir of wealth from which each country draws its share Given the necessary co-operation among nations, the size of this reservoir can be much ampler than it ever was in the past A stage seems, however, to have been reached in the world's economic progress when a less tendentious distribution of the contents of this reservoir among the countries has become the indispensable condition for its further growth Some countries, like India and China, must draw from it more than others like Great Britain and U S. A And the international arrangements that are brought into operation must ensure that employment and income expand at a much higher tempo in the less developed countries. Only thus can the appallingly low standards of living of millions of people be raised and an expansionist urge of an elemental character imparted to the economic processes by which mankind obtains its food and material comfort.

APPENDIX A

Automatism and Elasticity in Indian Currency System

A sound currency is required, in general terms, to be simple and certain and to secure stability, automatism and elasticitv Stability means here stability in the external and internal purchasing power of the currency unit. The external and internal stabilities are, under normal conditions, closely interrelated and not incompatible but in times of exceptional economic disturbance, emphasis may have to be shifted on to internal stability The proper criterion of the adequacy of a currency system lies in its capacity to secure balanced economic development by maintaining 'continuity of values' The indices of this development are not merely price-cost levels but also figures about trade, employment, prices of shares and movements of capital In the working of the Indian currency system too much importance has been attached to exchange stability (*i e*, stability of external purchasing power) and not enough to internal stability

Automatism

There can be no automatism in any absolute sense Some currencv systems may be more automatic than others Automatism in currency system cannot mean entire absence of control and management No system has been discovered which would relieve the monetary authority of all responsibility as to its working Even in so-called 'automatic systems' there is an element of control The pre-1914 gold standard is sometimes called an automatic standard becasue under it gold movements freely took place and by producing their effect on prices corrected disequilibria But the successful working of this system depended on the observance of some rules ('rules of the gold standard game') and the pre-

sence of a certain kind of economic environment. "The preservation of the system clearly depended upon the policies of Central Banks reflecting such variations as would have occurred under an automatic system of purely metallic currencies with no other types of money" An export or import of gold was allowed by the policies of central banks to produce its full effect through contraction or expansion of currency. If some central banks had adopted the policy of 'sterilizing' imported gold the automatism of the standard could be defeated, as was actually done in post-war years Nor would the system work automatically if the exchange parities chosen by the countries did not reflect internal prices and costs and consequently imposed a severe strain on their economic structures

Control and management in currency matters, as in other spheres of economic life, now meet general approbation Opinions may however differ about the objectives of such control and the methods thereof

The Indian currency system has not been automatic even in the qualified sense except between 1835 and 1893. The element of government control was definitely introduced from the time mints were closed to the free coinage of silver in 1893 Since then the system has been deliberately controlled and managed and as no monetary authority, least of all a government, can be infallible, serious mistakes were sometimes made The currency authority has been till recently the Government of India and it was under no obligation to expand and contract currency to the full amount of the sale or purchase of sterling. As the Hilton Young Commission observed in 1926. "There is no provision as to any organic relation between the total volume of token currency and the amount of reserves So far as the note-issue is concerned, the statutes provide for no minimum percentage of gold or sterling securities being held in the reserve as cover against the notes. Nor is there any such fixed relation in regard to the other form of token currency—the silver rupees The amount of the Gold Standard Reserve and the time and manner of its use are wholly within the discretion of the government The automatic working of the

standard is thus not adequately provided for in India and never has been . Under the Indian system, contraction is not, and never has been, automatic On occasions the obligation to buy sterling exchange has been discharged by the Government without any corresponding expansion of domestic currency" The Commission recommended gold bullion standard because, among other things, it would be automatic (*i e*, more automatic than the pre-war exchange standard.

The management of currency and credit has been transferred to the Reserve Bank of India since 1935. In so far as the Bank is under a statutory obligation to maintain 1*s* 6*d* sterling rate, it has to operate the currency system with a definite objective in view

Elasticity

Elasticity may be defined as the capacity of the currency system to meet the varying requirements of trade and exceptional demands of a crisis It is an important requisite for the Indian currency system because of the seasonal demand for currency to finance crop movements

The Indian currency system was based, till recently, on the principle of fixed fiduciary issue, *i e*, beyond a certain amount of currency issued against securities, expansion or contraction could take place at a rate exactly corresponding to the increase or decrease of the amount of metal or coins kept in the reserves The disadvantage of such a system is that currency cannot be expanded at a rapid rate owing to statutory requirement of 100 per cent reserve against additional note-issue and in times of emergency the system may break down Moreover, there was no arrangement by which additional currency could be provided for the requirements of internal trade

The Paper Currency Act of 1861 provided for a fiduciary issue (*i e*, issue against securities or invested portion of the reserve) to a maximum of Rs 4 crores The amount was increased to Rs 14 crores by 1911 During the War years (1914-1918) it was increased several times and stood at the end of War at Rs 120 crores In 1923 and 1925, provision was made to issue currency notes upto a maximum of Rs 12 crores against

hundis or internal bills of exchange The remarks of the Hilton Young Commission about this provision explain also the difficulty of introducing elasticity in Indian currency system " This provision has had beneficial effects in practice, but it is not in our opinion capable of development and improvement in connection with a reorganisation of the basis of Indian currency Any such provision depends for its proper operation on a plentiful supply of genuine trade bills But in India, for a variety of reasons, most of the internal trade is financed by a system of cash credits or by the advance of money against demand promissory notes It has, therefore, been found difficult to secure an adequate volume of bills as cover against the seasonal increase As a result, the currency authority has on occasions been forced to provide for the needed elasticity by regulating its holding of sterling securities in the Reserve."

The Commission recommended the adoption of the proportional reserve system under which the reserve bears a certain proportion to the note-issue, say, 40 . 100 If 40 units are added to the reserve, note-issue can be increased by 100 units and if 40 units are taken out, note-issue has to be contracted by 100 units. The range of expansion and contraction is, therefore, much wider than under the fixed fiduciary system The system has been incorporated in the constitution of the Reserve Bank of India which has to hold 40 per cent reserve of gold bullion, gold coin or sterling securities, the amount of gold coin and bullion being not less than 40 crores of rupees in value. To secure an emergent issue of currency, there is a provision for a reduction in the reserve ratio below 40 per cent with the sanction of the Governor General-in-Council and on payment of a graduated tax

These provisions are of value but to lend the much needed elasticity to the currency system it is necessary to encourage the habit of using cheques as the media of payment and to develop a bill market The Reserve Bank has already done a good deal in tempering the seasonal stringency and in keeping the rise in interest rates in the Indian money market under control It can render further assistance in the direction of the development of a bill market

APPENDIX B

Indian Economists' Manifesto

The rapid rise in the general price level during the past two years and the enormous expansion of currency in India are, we feel, causally related The unprecedented expansion of currency since the war began is due chiefly to the system adopted for financing the large British and other Allied purchases in India, under which the Government of India accepts payment in sterling and provides rupees in exchange For all these purchases India acquires, under present arrangements, sterling assets in London and against these there occurs an expansion of currency in India

The provision of internal finance in India for these purchases is a necessary concomitant of this accumulation of sterling assets in London and the responsibility for this financing falls on the Indian Government in the same manner as that for any part of the expenditure included in its regular budget The failure of the Government of India to recognise this fundamental and essential fact has prevented it from taking the proper view of the economic and financial situation in the country,

The Government seems to act as if it is enough for it to take care of its own budget deficit while meeting the needs of the British Government by printing more notes. This is a grave misreading of the whole situation and has resulted in an ever increasing expansion of currency unrelated to the needs of internal production and trade As a result, the inflationary spiral is already at work in India

The net inflationary gap in India's finances, counting in the finance made on behalf of His Majesty's Government, is thus being wholly filled by the creation of more currency. The inflation in India is, therefore, a deficit induced fiat-money inflation , It is the most disastrous type of inflation

The repatriation of India's sterling obligations does not act as an anti-inflationary factor, except to the extent to which the rupee counterparts are taken up by the public, but this has so far been only small in proportion

The increased liquidity preference of the public, which is at present tempering the rise in prices, cannot be expected to last long with a continuously rising price level The experience of many European countries after the Great War emphasises the danger of counting on a continuance of this phenomenon It is clearly a temporary phase and with a further rise in prices a preference for holding commodities instead of money might suddenly manifest itself.

Inflation is the most inequitable way of distributing the war burden and usually involves large transfers of wealth from the poorer and the middle classes to the richer classes It is also undesirable because it increases the cost of war and impairs the war effort by hindering production and distribution Its consequences to economic society are immediately felt, it, however, also holds the threat of bringing about later, political consequences of an even graver nature

We earnestly feel that immediate and drastic measures to check inflation are called for In this connection we urge on the Government of India the primary necessity of closing the 'gap' by increased taxation and borrowing Taxation in our opinion, should be raised to the highest practicable pitch, adjusted to shoulders that can best bear it We suggest a much steeper progression in income-tax rates, the laying of a maximum limit to individual consumption income and absorption of all profits above a limit, either in tax revenue or to be impounded into special loan contributions To increase the volume of borrowings to the required level, it is necessary to institute a comprehensive scheme of compulsory savings as well as a rigid control of all investment outlets.

This programme should be brought into effect with great rapidity However, it will take some time before the inflationary gap is completely closed and the total currency in circulation is to-day already greatly redundant, even at the existing high prices To tie up this vagrant purchasing power we propose the immediate initial steps of a blanket

control of all prices followed by a strict examination of all later allowable increases

In order to make this price control measure effective a policy of centralised supervision and direction of productive effort will be necessary This will in its turn involve equally strict regulation of transport and distributive machinery on a national scale A rationing of the essential necessities of life should be undertaken to as large an extent as possible An effective control of prices will involve a wage stop but this will mean no hardship as long as the price rise is stayed An equally strict profits stop is indicated as a corollary of this policy as well as independently on account of financial considerations

In our opinion, only such a comprehensive view of economic policy is capable of averting the grave economic, political and social consequences of the continuance of the present process of inflation We would also emphasize that the total liabilities undertaken by the Government of India, whether on their own account or on account of the British and Allied Governments, should not exceed the resources that they find possible to raise in pursuance of the policy outlined by us

APPENDIX C

Dearness Allowance, Inflation and Consumers' Subsidies

The Government of India and some of the Provincial governmets have granted dearness allowances to some classes of their employees. Similarly the Railway administration and private employers have given dearness allowance to the workers. But the issue has been raised in certain quarters that the grant of dearness allowance to low-paid Government employees sets into motion the inflationary spiral of rising wages (or salaries) and prices. The issue may be briefly examined here [1]

Three or four questions that at once arise are :—

(a) Is there any causal nexus at all between the grant of dearness allowance and rise in prices?

(b) If dearness allowance does eventually result in raising prices, to what extent will it do so?

(c) What will be the magnitude or force of dearne allowance as a factor in the price situation relativel to other factors at work ?

(d) Is there any implication that *if* dearness allowanc raises prices to some extent, *therefore* its paymen is undesirable ?

As regards (a), it may be admitted that *under certan conditions* the payment of dearness allowance will cause price to rise. If the amount paid as dearness allowance swells th existing quantity of monetary circulation or money income

[1] That the Government are anxious to limit the rates of dearnes allowance is clear from the *Draft Rules under the Excess Profits Ta Act*, 1940 recently published by them (and of November 1943) Th Rules provide limits upto which payments of dearness allowance, bonu and commission shall be admissible for purposes of deduction of Exces Profits Tax Earlier in October 1943, the Government had appointed a committee under the chairmanship of Sir Theodore Gregory to determine and report on what principles dearness allowance should be fixed

and the quantity of goods remains the same, that is, if it represents the creation of additional spending power against a constant supply of goods, it will certainly force prices upwards This will happen if money for the payment of the allowance comes out of either the idle balances of the Government or funds which otherwise would have been invested in Defence loans or spent on war effort, or through the taxes paid out of the savings of the richer classes lying idle in banks or such other savings which, if not drawn upon by taxes, would have been invested in Defence loans (In parenthesis, it may be observed that the spending of, say, one crore of rupees by Government on the purchase of grain for the army, or on munitions, is quite a different affair from the spending of the same amount by the Government employees, for the very essence of war economy is that the Government must spend more on war needs and obtain command of larger real resources and persons in, what may be called, the civil sector of economy spend less and have smaller command over real resources) If the funds for the payment of dearness allowance are obtained merely by the process of appropriation of spending power from one class of persons to transfer it to another class, then the Government discharges its purely normal function which has no inflationary significance

Reference may be made here to the evidence of theory and experience that in the 'vicious spiral' it is wages that chase prices The spiral almost invariably begins with an uncontrolled rise in prices generated by inflationary methods of war finance In the earlier stages and even in later stages, therefore, price rise continues to occur independently of stimulation by wage increases and in fact wage increases play a subordinate part Payment of dearness allowance to some classes of Government employees will obviously be an even less significant factor in the total situation

As regards (*b*), it is difficult to define in the absence of accurate data about the total number of low paid Government employees or their total salary bill the extent to which dearness allowance will raise prices (that is, if it raises them at all). It would, however, be hardly wide of the mark to reckon the total amount of dearness allowance as a

few tens of lakhs for any one provincial Government, and as a few crores, say 15 or 20 crores in a year, for the central and provincial governments together. (In the Punjab the total number of Government employees in 1939-40, was reckoned at 75,534 and the total amount of pay and allowance about Rs. 5½ crores). Dearness allowance may, of course, have to be adjusted to changes in prices and cost of living and this may well mean that its amount will increase in a cumulative manner But considering that the additional purchasing power in the form of note circulation has expanded in India by about Rs 250 crores between January 1943 and December 1943 alone, dearness allowance will, in any case, be a negligible affair

This necessarily leads to an inquiry into the forces at work behind the rise in prices in India For, if these forces are really amenable to control, introduction of an exciting factor in the shape of dearness allowance will be undesirable The position in a way is the same as during the last war when the leaders of working classes in England said to the Government . 'stop the rise in prices and we will stop the rise in wages' Unfortunately whether by the forces of circumstances, or by the weakness of Government, this counsel of perfection was not followed In India also an overpowering impersonal necessity seems to be the master, causing expansion of currency and inflation of money incomes Even granting that there is no inflationary issue of currency ('credit inflation,' as Sir J Raisman put it recently) in India and that currency is being expanded in a legitimate manner through Government purchases of commodities and services, there is no doubt that a situation (Sir J. Raisman called it 'temporary') has arisen in which a large amount of spending power is pressing against a more or less limited supply of consumers' goods This situation may perhaps be temporary in the sense that when the war is over, accumulated sterling against which currency, if expanded, may be used to purchase and import large quantities of goods into India But while the war is on, currency expansion is bound to continue and along with some other forces, such as speculative hoarding, will drag prices upwards—unless, of course, by extensive and heavy borrowing,

control of speculation etc, rise in prices is kept under control.[1] (One may here enter a caveat against the arguments of some Indian businessmen that what we are faced with is commodity scarcity and not monetary inflation They seem to overlook that scarcity of consumers' goods is an inevitable outcome of war, for resources must be drawn away from the production of such goods and devoted to the production of war goods What they seem to drive at is that the production of consumers' goods *as well as* the production of war goods can be increased, the tacit assumption being that there exist unutilised or unemployed resources in the country which can be used both ways But even so there must be *some* proportion maintained between the quantity of consumers' goods and the spending power to be used against them At present there is a big disproportion and it requires quite an amazing feat of faith to believe that this disproportion can be quickly rectified by devoting more resources to the production of consumers' commodities)

Coming now to (*d*), as the expansion of currency continues and prices continue to rise, it becomes difficult to maintain any case against the payment of dearness allowance, even if it be admitted that dearness allowance is a price exciting factor Expansion of currency, as is well known, must take the form of an increase in money incomes of some persons or classes before it exerts its influence on prices of consumers' goods If dearness allowance is not paid, it will only mean that the money incomes of one class of persons are prevented from increasing, while large scale government spending is inflating the incomes of other classes Relatively to other classes, therefore, and also

[1] Professor Brij Narain has worked out a law governing the variation of note circulation from the examination of statistics between September 1941 and December 1942 This law connecting X (time) and Y (note circulation) is given as

$$Y = 196.4 + 59.7X$$

If this law continues to govern the increase of note circulation, the total amount of note circulation in future would be as follows

March	1943	614	crores	March	1944	853	crores
June	1943	674	,,	June	1944	913	,,
Sept.	1943	734	,,	Sept	1944	973	,,
Dec	1943	793	,,	Dec	1944	1032	,,

absolutely, the real incomes of this particular class are being reduced. In an absolute sense there must, of course, be a cut in the consumption of all the classes, if war is to be effectively prosecuted But there must be at the same time an equitable distribution of the burdens thus imposed The real incomes of employees getting fixed and low money incomes have, in fact, already been reduced a little too much relatively to the incomes of other classes Dearness allowance paid now can prevent further deterioration and not compensate for a past injury.

Is there any alternative to the payment of dearness allowance which will serve the same purpose and yet be not open to the objections that can be urged against the latter? The alternative, obviously, is a guarantee that for these oyees essential commodities of consumption will be available at fixed and low prices The employees themselves may prefer this because dearness allowance usually tends to lag behind rising prices But the Government must place themselves in a position to give such a guarantee

Whether or not dearness allowance is given, there is no escape for the Government from the time, worn and well-tested remedies of price control and rationing if all the consumers with fixed or low incomes are to be assured an adequate minimum of the essential articles of consumption Price control and rationing have their separate function but serve a common purpose Rationing secures a minimum of necessities for all and price control ensures that that minimum is available at a fair or reasonable price. Taken together they go far but perhaps not far enough For the price that is fair for producers and some classes of consumers may still be unfair or unreasonably high for large bodies of consumers with low incomes Here is a lacuna which the Government can remove by purchasing commodities at the fair price and selling them to low income consumers at a price which they can afford to pay, the difference between the two prices representing the financial cost of the transaction to the Government It will be seen that this subsidisation of consumption—or consumer's subsidies—will benefit the needy few just as price control and ationing

benefit all This need not, however, be the general rule and consumers' subsidies can be given and have been given in countries like U K, U S. A and Canada to lower prices of certain essential goods for the consumers in general[1] For apart from the fact that all can be needy when it comes to the possibility of paying a lower price, there is the vital consideration that lower prices for all mean a lower cost of living and the stabilisation of cost of living at a low level is a useful check to the prices feeding on themselves by raising wages and cost of production and starting what Pigou has called 'wage-induced inflation'[2] In this sense—and in this sense alone—consumers' subsidies can be said to be anti-inflationary. For otherwise the cost of subsidies itself must be met and if it is met by inflationary finance, a lot of superfluous purchasing power will go into the economic system creating an inflationary situation and imperilling price control itself

[1] In England food subsidies amounted to over £102 million in 1942 (I.L O *Food Control in Great Britain*, pp 48-49) In U S A food subsidies have formed an important part of the anti-inflation programme but the effect of the Anti-Subsidy Bill recently passed by the House of Representatives would be to make subsidies illegal after December 1943

[2] *Economic Journal*, 1941 pp 440-42 It is necessary to note that subsidies if they are to accomplish their purpose, should be heavy enough to bring the price within the reach of the lower income groups otherwise subsidy is a "waste of public funds—better to double the subsidy if necessary or drop it entirely" (*Food Control in Great Britain*, p 9)

APPENDIX D

Currency Plans, Sterling Balances and Bombay Plan

The British Plan contains the following provision in respect of abnormal war balances .—

"The position of abnormal balances in overseas ownership held in various countries at the end of the war presents a problem of considerable importance and special difficulty A country in which a large volume of such balances is held could not, unless it is in a creditor position, afford the risk of having to redeem them in bancor on a substantial scale, if this would have the effect of depleting its bancor resources at the outset At the same time, it is very desirable that the countries owning these balances should be able to regard them as liquid, at any rate over and above the amounts which they can afford to lock up under an agreed programme of funding or long-term expenditure Perhaps there should be some special over-riding provision for dealing with the transitional period only by which, through the aid of the Clearing Union, such balances would remain liquid and convertible into bancor by the creditor country whilst there would be no corresponding strain on the bancor resources of the debtor country, or, at any rate, the resulting strain would be spread over a period" (Para 34)

The American Plan gives profuse detail regarding the treatment of abnormal war balances. Under it, the Fund has the power .—

" To buy from the Governments of member countries, abnormal war balances held in other countries, provided all the following conditions are met

(*a*) The abnormal war balances are in member countries and are reported as such (for the purpose of this provision) by the member Government on date of its becoming a member

(*b*) The country selling the abnormal war balances to the Fund agrees to transfer these balances to the Fund and to repurchase from the Fund 40 per cent of them (at the same price) with gold or such free currencies as the Fund may wish to accept at the rate of 2 per cent of the transferred balances each year for 20 years beginning not later than 3 years after the date of transfer

(*c*) The country in which the abnormal war balances are held agrees to the transfer to the Fund of the balances described in (*b*)

above, and to repurchase from the Fund 40 per cent of them (at the same price) with gold or such currencies as the Fund may wish to accept, at the rate of 2 per cent of the transferred balances each year for 20 years beginning not later than 3 years after the date of transfer

(*d*) A charge of 1 per cent payable in gold, shall be levied against the country selling its abnormal war balances and against the country in which the balances are held In addition a charge of 1 per cent, payable in gold, shall be levied annually against them on the amount of such balances remaining to be repurchased in each country

(*e*) If the country selling abnormal war balances to the Fund asks for foreign exchange rather than local currency, the request will not be granted unless the country needs the foreign exchange for the purpose of meeting an adverse balance of payments not arising from the acquisition of gold the accumulation of foreign balances or other capital transactions

(*f*) Either country may at its option, increase the amount it repurchases annually But, in the case of the country selling abnormal war balances to the Fund, not more then 2 per cent per annum of the original sum taken over by the Fund shall become free, and only after 3 years shall have elapsed since the sale of the balances to the Fund

(*g*) The Fund has the privilege of disposing of any of its holdings of abnormal war balances as free funds after the 23 year period is passed or sooner under the following conditions —

(i) its holdings of the free funds of the county in which the balances are held fall below 15 per cent of its quota, or

(ii) the approval is obtained of the country in which the balances are held

(*h*) The country in which the abnormal war balances are held agrees not to impose any restrictions on the use of the instalments of the 40 per cent portion gradually repurchased by the country which sold the balances to the Fund

(i) The Fund agrees not to sell the abnormal war balances required under the above authority, except with the permission or at the request of the country in which the balances are being held The Fund may invest these balances in ordinary or special Government securities of that country The Fund shall be free to sell such securities in any country provided that the approval of the issuing Government is first obtained

(j) The Fund shall determine from time to time what shall be the maximum proportion of the abnormal war balances it will purchase under this provision Abnormal war balances acquired under this provision shall not be included in computing the amount of foreign exchange available to member countries under their quotas" (Para 9),

The Revised American Plan is reported to contain the following provision

"During the first two years the Fund may buy from the governments of member countries blocked balances held in other member countries, not exceeding in the aggregate 10 per cent of the quotas At the end of two years the Fund shall propose a plan for the gradual further liquidation of blocked balances"

The Canadian Plan makes the following provision in respect of such balances

"During the first two years of operation the Union shall have the right to purchase abnormal wartime balances held by member countries in other member countries for the national currency of country selling such balances or for foreign exchange needed to meet current account deficits in such country's balance of international payments, in amounts not exceeding in the aggregate 5 per cent of the quotas of all member countries At the end of two years of operation the Governing Board shall propose a plan for the gradual further liquidation in whole or in part, through the Union, of abnormal wartime balances lying to the credit of member countries in other member countries and other financial indebtedness of a similar character If the Governing Board feels unable to recommend that the Union's resources be used for this purpose it shall have the duty to propose some other method by which the problem can be considered," (VIII)

There is no finality about these, as about the other provisions, of the currency plans. But as it is of the greatest importance for India to secure the free-est convertibility of her sterling balances into foreign exchange and to effect their speediest liquidation, it may not be futile to examine these provisions. The British plan seeks to serve the interests of both the creditor and the debtor on this account by visualising an arrangement under which the bancor resources of the debtor country will not be depleted and such amounts of abnormal balances of the creditor as are not set aside by agreement for long-term expenditure will be rendered liquid and convertible into bancor It is necessary to take notice of this reference to locking up of a part of the balances under an agreed programme, for it may well imply that a portion of these balances will be frozen for some considerable period The American plan provides for the purchase of balances by the Fund but it is not clear what the country selling them will get in return. There are two possible interpretations the first being that it will get in

return foreign exchange and the second that it will get its local currency (presumably out of its own contribution to the Fund)[1] Under (*e*) of the provision given above, foreign exchange will be made available to the country only if it is needed for meeting an adverse balance of payments Now that means that if India runs into an adverse balance of payments by importing large quantities of capital and other goods, there would be no difficulty in securing the necessary amount of foreign exchange to pay for the excess imports But it is necessary to read this provision of the Plan along with the other which provides for rationing of scarce currencies, for this latter provision would restrict the right to secure imports from some countries (like the United States, for example) Moreover, both the revised American plan and the Canadian plan contemplate that during the first two years of its operation, the international monetary authority will purchase only as much of the balances as would come up in value to a small percentage—10 (American) or 5 (Canadian) —of the quotas of all member countries, *i e*, from $400 to $500 million Under the American plan, the balances purchased by the Fund will be repurchased by both the countries (*i e* in the case with which we are concerned, by both England and India), each repurchasing 40 per cent of the balances at the rate of 2 per cent per annum for 20 years For repurchasing them, each country will pay to the Fund foreign exchange or gold The outcome of all this process will be that India will have at her disposal foreign exchange to make purchases in the world market at once, she will then over a period of 20 years part with foreign exchange or gold in her possession to get back sterling which she can then utilize, over the same period England will by parting with foreign exchange or gold accumulated by her through her export surplus get sterling released from the Fund England will, therefore, discharge her obligation on account of these balances to India by directly exporting to India to the extent of 40 per cent of the balances and

[1] For the first interpretation which has been supported by Dr White himself refer to *Eastern Economist* 1943 pp 518 20 and 643 and for the second interpretation to the *Economist*, 1943 p 558

by sending out exports to other countries (and handing over the proceeds thereof to the Fund) to the extent of another 40 per cent. The whole transaction will be completed over a period of 23 years, though at the end of that period there would still remain, even after taking into account the charges mentioned in (*d*), some undisposed of balances The gain accruing to India from this mechanism would obviously consist in the free command over international purchasing power made available by the Fund at an early date. In the absence of such a mechanism India will have to make large purchases in England at such a rate and in such goods as might suit the set-up of post-war British economy. But it is obvious that a period of 23 years is rather long and might be reduced to about 15 years. Further, it may be suggested that a rate of more than 2 per cent per annum should be specifically laid down to do away with the unnecessary complication of undisposed of balances at the end of the period.

A Plan for the Economic Development of India

Apparently there is no direct connection between the liquidation of sterling and the preparation of a post-war economic plan for India, yet it would be hard to imagine a more thoughtless act than an effort to absorb the commodity equivalent of sterling balances into the texture of Indian economy in a haphazard and disorderly manner. These balances are a valuable asset and it is necessary not only to discover means of their early conversion into goods and services but also to determine in advance the *nature* of goods and services into which they should be converted. Obsolete machinery and stores which other countries may only be too ready to pass on to India after the war are obviously not what India would like to have But then it must be clear what exactly India will have in return for her balances An effort to pass from vague opinion into firm decision on this point opens up a whole vista of thought about the future economic development of India.

A few dominant though divergent lines of thought on the subject of economic planning for India are already there

for a careful student to pursue They are embodied in the writings of Indian economists, businessmen and industrialists, adherents of the Gandhian philosophy and the ardent preachers of the socialistic doctrines. A kind of synthesis of these may be found in the provisional conclusions of the National Planning Committee that held its deliberations for over two years (1938-40) under the chairmanship of Pandit Jawaharlal Nehru A valuable contribution to thought has now been made by eight prominent Indian industrialists who have issued a brief memorandum outlining a plan of economic development for India [1] This has come to be known as the Bombay plan

The plan, by its authors' own confession, is neither complete nor very comprehensive Its object is "merely to put forward, as a basis of discussion, a statement in as concrete a form as possible, of the objectives to be kept in mind in economic planning in India, the general lines on which development should proceed and the demand which planning is likely to make on the country's resources" The important omissions in the plan are the discussion of the problem of distribution and of the extent of control to be exercised by the state over economic activities These questions are, however, intended to be dealt with in a separate report. It is recognised that the success of the plan will be conditioned by the international situation as well as the people's response to it within the country.

Starting with the two inescapable assumptions that the economic unity of India will be maintained and that a national government will come into power at the centre, the plan sets out as its objective the tripling of national income or the doubling of per capita income in a period of fifteen years This threefold increase in national income will be spread over industry, agriculture and services in different proportions so as to bring about a more balanced structure of Indian economy, the percentage increase in the three sectors being respectively 500, 130 and 200. The attainment of this objective will involve a total capital outlay of 10,000 crores of rupees of which industries will claim 4,480 crores

[1] *A Plan of Economic Development for India*, January 1944

(basic industries claiming 3,480 crores and consumption goods industries 1,000 crores); agriculture, 1,240 crores; communication, 940 crores; education, 490 crores; health, 450 crores, housing, 2,200 crores and miscellaneous, 200 crores. This outlay will be spread over three periods of five years each—three five-year plans—increasing from 1,400 crores in the first period to 2,900 crores in the second and 5,700 crores in the third.

A discussion of the various aspects of this outline of a plan would be here out of place and irrelevant Viewed against the background of India's poverty and the great potentialities of her resources, the plan is neither unreasonably ambitious nor, given the necessary conditions, impracticable. Of the greatest interest in the present context is its financial aspect, the question of obtaining 10,000 crores of rupees to be spent on various development projects. Both external and internal finance will be required, external finance to make payments for machinery and other goods to be imported from abroad and internal finance to mobilise resources within the country. The plan proposes to tap the following sources for the purpose.

	(Rs. crores)	
External finance.		
Hoarded wealth	300	
Sterling Securities	1,000	
Balance of trade	600	
Foreign borrowing	700	2,600
Internal finance:		
Savings	4,000	
'Created money'	3,400	7,400
	Total	10,000

The explanation given in the plan of the manner in which these sources of finance can be tapped is a little too terse, the *modus operandi* of the plan has not been fully set out, and the critics of the plan have naturally fastened on the financial part of it. It will perhaps help clarification of ideas if for a moment the plan is stripped of its money integument

and it is realised that after all what is required to attain the targets laid down in the plan as regards food, clothing, etc., is a full equipment of tools, implements, machinery, fertilisers, raw materials and all the other aids to production If the end is the tripling of the sumtotal of the material requisites of well-being, the means is the capital equipment and the means must be adequate to attain the end Building up of the capital equipment will necessarily be a laborious process but there will hardly be any difference of opinion that it can be done in four ways (i) by increasing production and using the increased production not for consumption but for capital construction, or to put it briefly, by saving out of increased production , (ii) by increasing the *proportion* of saving out of current income, i e , by an increased rate of saving whatever be the extent of production This must involve curtailment of consumption or tightening of consumers' belts , (iii) by using up such past savings as have not so far been converted into productive capital equipment, and (iv) by borrowing from other countries. The authors of the Bombay plan seem to be quite aware that all the four methods will have to be combined in India In respect of (i), it may be stated, in view of the controversy centring round 'created money' mentioned in the plan, that there is not the slightest objection, theoretical or practical, to the created currency being used to bring about increased output In fact, pumping of newly created money into circulation through judiciously selected construction programmes is often the best method of stirring up the unutilized resources and idle capacity of the economic system Such created finance justifies itself, and is offset by increased production of real wealth and the consequent increased saving It *evokes* the corresponding amount of saving and thus represents 'created' and not (as is wrongly thought) 'forced' saving But it is well to recognise that created money *can be* used not to bring about increased production and saving but to withdraw resources from people's consumption in a surrerptitious manner. Used thus, it takes on the character of 'forced saving'—saving imposed in an indiscriminate manner by inflationary finance Such an imposition occurs (or is deliberately made) either

when there are no idle resources to draw upon or when such resources cannot be put to use due to certain limitations (as in India during the war). Much argument at cross purposes could be avoided if it were made clear which of the above two uses of created money is in view when this particular provision of the plan is criticised. Created money in the first sense will be a wholesome and necessary means of saving but not in the second sense.[1] That it should not be used in the second sense goes without saying but the scope for using it even in the first sense will become less and less as the plan gathers momentum and all the available resources are pressed into use.[2] The (*ii*) way mentioned above, *i e*, of increased *proportion* of saving will be the chief method of financing the plan and its contribution to the total finance required under the plan will steadily increase with an increase in current production and income. The curtailment or limitation of consumption which it will involve will, however, steadily grow less as the growing capital equipment brings into being an increasing supply of consumers' goods At this stage it may be mentioned that a favourable balance of trade cannot be used as a means of finance except in a well defined sense. For if all the visible and invisible items of trade of country such as goods, services, etc. are taken into account there can be no such thing as a favourable balance on current account (though such a balance can no doubt arise if a country is making a loan or paying a tribute or repaying it debt to another country and creating for that purpose an export surplus). Normally, therefore, a favourable balance of

[1] It is, however, necessary to admit that created money even in the first sense, though offset by increased production over the whole economy, may give rise to a maladjustment between monetary and real resources in the two sectors of economy—the capital construction sector and consumption sector Though there may not be too much money in the economy as a whole, there may be a little too much of it in the beginning in the consumption sector This lack of balance—or inflationary gap—will have to be rectified by withdrawing money from the consumption sector and to this end by instituting price control rationing, etc

[2] The authors of the Plan have given no indication as to how much of the created money' and other types of finance will be required at each of the three stages of the plan, though they have mentioned that in the first stage the degree of dependence on external finance would be high.

trade will not be available for financing the plan But if exports are increased by means of increased production—*i e*, by using (*i*) method above—or imports decreased by cutting out the consumption of non-essential goods—*i e* by using (*ii*) method—the excess of exports over imports can be used to that extent to import capital goods The (*iii*) method of mobilising past savings will, of course, involve the use of the hoards of precious metals and the sterling balances The (*iv*) method of foreign borrowing requires no elucidation

These are then the means of building up or acquiring capital equipment and all the sources of finance mentioned in the Bombay Plan will fall in their proper place under the classification given above Given these means, the next step will be the determination of the relative amounts of the total capital equipment that can be obtained from within the country and from other countries To purchase it from other countries it will be necessary to have that much command over foreign currencies The plan rightly mentions hoards, sterling balances, foreign borrowing and favourable trade balance—this last understood in its well-defined sense—as the means of obtaining this command But it does not make it clear that not the whole of the sterling balances can be used for the purpose, for a portion of them may have to be set apart as a kind of exchange reserve to be used in emergencies or to smooth out exchange fluctuations Nor is it clear why the hoarded wealth should not be available within the country also—as internal finance In fact the distinction between external and internal finance need not be drawn so very sharply once the means by which the total finance can be raised are explicitly stated Some means will then be available predominantly for raising external finance and others for internal finance

Before concluding this note it is necessary to add a few general observations An essential pre-requisite for the successful execution of the plan is a high measure of international approval and co-operation The amount of external finance in the plan has been placed at Rs 2,600 crores which works out on the average to Rs. 173 crores per year Whether the international economic system will allow the smooth

transfer of this much finance and whether other countries will allow the harnessing of their resources to provide for India's reconstruction requirements to this extent will obviously depend upon the character of forces that will emerge after the war. Another consideration is that an expanding Indian economy will have to constantly adjust itself to the economies of other countries and for this purpose it will have to insulate itself from the economic fluctuations occurring in the outside world by a series of controls over trade, prices, exchange, etc. That would necessarily imply an all-embracing and intensive state regulation of all spheres of economic activities. Finally, the assumption of a national government is basic to the whole plan. It may not be fair to the present Government of India to assert that in spite of a number of post-war reconstruction committees functioning for the last two years they are incapable of preparing the blueprints of a new economic order for India, for we are assured that "the immediate task of investigation and planning is already well in hand and some of the official reports and data will shortly be released for the information of the public "[1] But the Government of India have to honour the commitment and discharge the obligations that the British Government have on account of historical and other reasons run into with numerous interests, large and small, within the country and without while real honest planning is bound to involve *some* limitation of private property rights, *some* 'devesting of vested interests' It would appear that their most effective contribution to the task of drawing up a plan can lie in the direction of providing a base of carefully compiled and accurate statistical data covering all the regions and provinces and all kinds of economic activity. This, it may be suggested, can be made best by setting up a network of Institutes of Economic Enquiry all over the country The Institutes should be generously financed, should enjoy the widest powers to collect information and should function under the guidance of a small central committee consisting of Indians representing the main walks of economic life and economic thought.

[1]Budget Speech, 1944, para 57

APPENDIX E

General Budget and Railway Budget for 1944-45

To maintain some sort of continuity between the subject matter of this book and the information now available from the General Budget and the Railway Budget presented to the Indian Legislature in February 1944, it will be convenient to bring the salient features of the two budgets under the following headings

(i) Magnitude and methods of war finance, (ii) Inflation—its cause and remedies, (iii) Disposal of sterling balances and (iv) India and post-war currency plans

War Finance—magnitude and methods[1]

The table given below shows the magnitude of the defence expenditure for 1942-43 (actual), 1943-44 (budget and revised) and 1944-45 (budget)[2]

	1942-43 (Accounts)	1943-44 (Budget Estimate)	1943-44 (Revised Estimate)	(1944-45) (Budget Estimate)
Revenue portion	214 6	182 8	262 6	276 6
Capital portion	52 5	16 9	38 3	24 6
Total	267 1	199 7	300 9	301·2

While the figures of total defence expenditure given above reflect the expansive character of war effort in this country, they hold no promise, not at any rate for another year, of any abatement of the financial burden of war In fact, the revised

[1] Refer to pages 138-49

[2] *Explanatory Memorandum on the Budget* 1944, p 17

estimate of defence expenditure for 1943-44 exceeds the budget estimate by more than Rs 100 crores There is, however, some comfort to be derived from the Finance Member's observations that the setting up of the South-East Asia Command under Lord Mountbatten does not of itself add to India's liability for defence expenditure and that no further substantial increase in the overall quantum of war demands on India's resources can be met without grave risk of economic collapse It is also reassuring to know that in spite of the impending increase in the scale of war operations, no departure will be made from the principles of the Financial Settlement which governs allocation of defence expenditure between India and United Kingdom. It need hardly be reiterated in view of the burden of mounting war expenditure now borne by India that the Settlement is in no way generous to India A case can in fact be made out for revising the Settlement so as to lighten India's burden.

As regards the methods of war finance, the aid of both taxation and borrowing will be invoked to a far greater extent than before

(a) *Taxation* The new taxation proposals may be summed up as under ·

Tax	*To be levied for the first time or increased*	*Rate*
Income Tax	Taxable minimum to be raised to Rs 2,000	
Surcharge on Income-tax	To be raised on incomes above Rs 10,000	By 2 pies on incomes between Rs 10,000 and Rs 15,000 and by 4 pies above Rs 15,000
Surcharge on super-tax	To be increased	By half an anna on slabs of income between Rs 35,000 and Rs 2 lakhs
Corporation tax	To be increased,	To 3 as in the rupee—rebate of one anna to be given for income not distributed in dividends of a specified kind

Tax	*To be levied for the first time or increased*	*Rate*
Surcharge on customs	To be increased	From 20 per cent to 50 per cent in the case of tobacco and spirits
Excise duty on unmanufactured tobacco and on cigars and cheroots	To be increased	According to a complicated scale
Excise duties on tea, coffee and betelnuts	To be levied	2 as per lb

In addition to these proposed taxation measures which are estimated to yield Rs 23½ crores, the Government have under active consideration the possibility of an estate duty on non-agricultural property, which would be levied by the centre but of which the proceeds would be assigned to the provinces

To this list of taxation proposals, it is necessary to add the proposal to levy a 25 per cent surcharge on railway fares for all classes of passengers (including fares for military passengers travelling at their own expense) with effect from 1st April 1944 This particular proposal for a kind of indirect taxation is, however, designed not to strengthen revenues but to drain off a part of the purchasing power now pressing on the limited quantum of travelling facilities available for the public. The yield resulting from the increase in fares will not be used to make larger contributions from railway revenues to general revenues, but will be placed in the Railway Reserve and earmarked for an amenities fund for lower class passengers[1] Under the arrangements now in force for the determination of railway contribution to general revenues, the amount of contribution will be as follows[2] —

	(in crores of rupees)
1942-43 (Actual)	20 13
1943-44 (R E)	32 27
1944-45 (B E)	31 37

[1] Budget Speech of the War Transport Member, 1944-45, para, 14

[2] *Explanatory Memorandum on the Railway Budget*, 1944-45, p 26

(*b*) *Borrowing.* Borrowing was described as the sheet anchor of Government's war finance in the last budget speech and once again the Finance Member has strongly emphasised its importance. That the achievement in this regard has been rather striking during the last 12 months will be evident from the investments in the Defence Loans from the 1st February 1943 to the 31st January 1944, amounting to a record figure of Rs 115 crores Each one of the loans floated during the last year has yielded substantial amounts. the third 3 per cent Defence Loan, 1951-54, Rs 55 crores, the fourth 3 per cent Defence Loan, 1953-55, Rs 81 crores (for a period of seven months only), the special issue of 3 per cent Defence Bonds 1946, Rs. 19 crores, the special issue of 3 per cent loan 1963-65, Rs 15 crores, 3 per cent Funding Loan, 1966-68, Rs. 25 crores and a further issue of the Funding Loan, Rs 4½ crores (upto February 1944 only). The probable yield of the Prize Bond issue is at present too early to estimate. Besides these investments in Defence Loans, the sales of rupee counter-parts of 2½ per cent and 3 per cent undated Sterling Stock brought in Rs 93 crores from the 1st February 1943 to 31st January 1944 The loans that were floated last year by the provinces to repay a part of the consolidated debt to the Centre account for the inflow of purchasing power to the extent of about Rs 8 crores, Taken together these investments amount to Rs. 279 crores from the 1st February 1943 to 31st January 1944, bringing, the total from the out-break of war to February 1944 to Rs. 547 crores. Apart from these there has also been a more intensive drive for the mobilisation of small savings The main items in this part of the borrowing programme are the replacement of Post Office Ten-Year Defence Savings Certificates by Twelve-Year National Savings Certificates and the raising of the rate of interest on Post Office Savings Bank Deposits from 1½ per cent to 2 per cent per annum from the 1st October 1943. A National Savings Commissioner has been appointed to direct and control the small savings movement from the Centre A scheme has also been evolved to provide for the

employment of authorised agents on a commission basis whose function will be to collect money for investment from villagers, purchase certificates on their behalf and deliver them in the villages The savings drive will be pushed forward by the establishment of savings bureaux in all important towns, extensive publicity and propaganda and the extension of the movement to women's organisations through an honorary lady organiser

Saving Schemes—Two saving schemes of a compulsory character, one of them a revised version of an existing scheme, are proposed to be introduced during the coming year The first provides for the compulsory deposit of 19/64 of the excess profits tax, instead of 1/5th as hitherto, thus immobilising the whole of the excess profit remaining after the payment of excess profits tax, income tax and the super tax. The second scheme is of a limited type and provides for only a temporary deposit of advance payments of tax on those incomes from which tax is not now deducted at the source, such as income from property, business, profession or vocation The assessee will have the option to pay tax quarterly either on the basis of his last assessed income, or of his estimate of current earning Government will pay 2 per cent interest on all sums paid in advance under the scheme, but if the assessee under-estimates the amount payable beyond a certain limit, he will have to pay penal interest The sums thus collected will be treated not as revenue but as deposits to be taken to revenue when the regular assessments are made.

Lease-Lend Aid—Discussions for a direct Lease-Lend agreement between India and U S A were started in 1943 but were suspended later on due to the difficulty of facing certain implications of such an agreement from the standpoint of India's post-war trade policy Lease-Lend aid, therefore, continues to be received by India under the agreement between the United States and the United Kingdom, though no accurate idea is available of its magnitude The Finance Member considered it reasonable to assume that India's share in the total aid upto the end of 1944-45 would not be less

than Rs 117 crores As regards the Reciprocal Lease-Lend Aid rendered by India, the estimated cost on the present information will be during the years 1943-44 and 1944-45 about Rs 26 crores and Rs. 43 crores respectively, so that the total amount of such aid upto the end of 1944-45 will be a little more than Rs 81 crores.

Inflation—its cause and remedies[1]

For the first time one finds in the Budget Speech a clear recognition of the basic cause of inflation in India It is now admitted that rather more than half of the war expenditure in the country is incurred by His Majesty's Government and other Allied Governments, and that while the expenditure debitable to the Indian Budget has been fully met by taxation and borrowing throughout the period of the war, the Government has not at all times been able to raise sufficient rupees from the market to finance its total outlay. The rupees issued to fill the gap have led to an increase in the free purchasing power and though they have been backed by sterling assets, have produced inflationary effects During the current year *i e*, 1943-44, it is revealed, the gap between the total incomings and total out-goings of rupees would be of the order of Rs. 250 crores.

This gap must be completely bridged or very considerably narrowed down if the insidious inflationary process is to be arrested The Finance Member has described in this connection the measures already taken by the Government to fight the menace of inflation Both physical controls and direct monetary regulations, along with increases in the supplies of suitable articles by imports or production, have been utilized for the purpose The limitations of both kinds of measures are fully recognised, but the enumeration given by the Finance Member cannot be called complete In respect of physical controls, for example, the difficulties arising from the vast size of the country, the educational backwardness of

[1] Refer to pages 159 67

the general population and the insufficiency of experienced and capable personnel have been stressed but those arising from the psychological resistance of the public have not received even a bare mention Similarly the difficulty of withdrawing purchasing power from the possession of persons who are not habituated to investment in Government securities is mentioned but that will not meet the contention of those who hold that the Government can never get back the purchasing power at the same rate at which it is being injected into circulation For the future, the Government intend to pursue their attack on inflation from three directions simultaneously In the first place, the net overall demand placed upon Indian resources will be controlled and stabilised and an increase in it compensated, as far as possible, by imports of food, bullion or other capital and consumers' goods Secondly, the rate at which rupees are withdrawn from circulation will be intensified until it equals the rate at which they go in circulation Thirdly, the price control will be maintained and extended

Three other measures for checking inflation have also been referred to in the Budget speech Of these, an enhancement in the rate of interest on Government loans is found objectionable on the grounds that it will heavily mortgage the future development of the country and have immediate adverse effects on the institutional investors Similarly the proposal that the Allied governments should borrow directly in the Indian market is found of little merit, for it will not in any way stimulate investment in Government securities As regards gold sales their main advantages as an anti-inflationary measure are said to lie in the direction of offering an alternative mode of investment to those who do not want to invest in Government securities, directly absorbing purchasing power and filling to some extent the gap caused by the restriction of the imports of goods But no information has been supplied about the extent of profits made on these sales and no attempt has been made to answer the allegation that the Allied governments are 'profiteering' on these sales.

Disposal of Sterling [1]

Another important problem is the utilization of sterling that is accumulating with the Reserve Bank and is estimated to amount to approximately Rs. 950 crores on the 31st March, 1944. The possibilities of repatriation of India's public debt, according to the Finance Member, have been very nearly exhausted. On the 4th February 1944, an amount of £8·8 million was paid off on account of $3\frac{1}{2}$ per cent Railway Debentures. Another £6 million will be shortly utilized to acquire Madras and Southern Maharatta Railway and the South Indian Railway. The total amount of sterling obligations redeemed to date, including dated and undated Government of India Stocks, Railway Annuities, Railway Debentures, purchase of railways and one-fourth of Chatfield debt, is about £350 million Now only a small amount of £$11\frac{1}{2}$ million of Government of India Stock and Railway Debentures remains the outstanding sterling liability As regards the funding of the floating debt incurred by the Government for purposes of repatriation, further progress has been made and the finance obtained from the Central Bank has been reduced to only Rs 20 crores (against Rs 160 crores last year).

In view of the heavy accumulation of sterling and the apprehensions entertained regarding its convertibility into dollars, it affords some satisfaction to know that a dollar fund is going to be created by the Government as an integral part of the Reciprocal lease-lend arrangement. To this fund will be credited from now onwards a part of the dollars accruing from India's exports to U S. A. These amounts will be held in a dollar account by the Reserve Bank of India with the Bank of England and will be available for India's development purposes after the war.

India and Post-war Currency Plans [2]

With regard to India's position in relation to currency plans, the Finance Member has stated that India has not so far

[1] Refer to pages 183-98 [2] Refer to pages 225-32

been directly represented in the discussions that have been taking place on these plans in Washington, though the Government of India have been kept fully informed of their progress. The discussions are still on a technical plane and have not reached the stage of negotiation for a formal agreement The Government of India intend to bring the whole subject for discussion before the Legislature before formulating their views It is expected that in due course a conference of all the United Nations will be called at which India will be represented.

APPENDIX F

Recent Statistics*

Table I.—Volume and velocity of currency circulation

(In crores of rupees)

Year	*Month*	*Notes in circulation*	*Demand deposits of scheduled banks*	*Rupee coin absorbed*	*Small coin absorbed*	*Velocity of bank deposits*
1944	January	853 7	502 7			
	February	867 5	516 3			
	April					
	July					
	October					
	December					

Table II.—Assets behind note-issue

(In crores of rupees)

Year	*Month*	*Total note-issue,*	*Notes in circulation*	*Gold coin and Bullion*	*Sterling securities*	*Rupee coin*	*Rupee securities*
1944	January	862 9	853 7	44 4	744 8	15 3	58 3
	February	880 0	867 5	44 4	763 8	13 5	58 3
	April						
	July						
	October						
	December						

Table III.—Movements of prices (last week of each month).

Month and year	CALCUTTA *July 1914=100*			ECONOMIC ADVISER'S *Week ended 19th August=100*	
	Cereals (8 items)	Pulses (6 items)	General	Food and tobacco (8 items)	General
January 1944	234	392	297	286	237
February 1944	245	327	300		
April 1944					
July 1944					
October 1944					
December 1944					

*These more or less blank tables are intended to serve as pegs on which the more enthusiastic reader may hang the latest information

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(Errata overleaf)

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58	2	prices	prices bring
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146	14	1000	1500
147	8	$800	$800 million
151	30	*economic system*	economic system
156	15	has	have
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